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ANALYSIS OF MONTENEGRO'S PUBLIC DEBT FOR THE PERIOD 2006–2018

Ministarstvo javne uprave

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Analysis of Montenegro’s Public Debt for the Period 2006–2018
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Ministarstvo javne uprave

ANALYSIS OF THE LEGAL AND FINANCIAL FRAMEWORK REGULATING THE SECTOR OF PUBLIC SPENDING

The Law on the Budget and Fiscal Responsibility[1] essentially defines the sector of public spending. As stated in Article 1, the Law, "defines the planning and implementation of the budget, fiscal responsibility, lending, guarantees and other matters of importance to the budget of Montenegro (hereinafter: state budget) and the budgets of local self-government units (hereinafter: municipal budgets)".

The law also defines the adoption, recording and management of the budget. In this segment the revenues, expenditures and ascertaining of a surplus/deficit are determined.

Article 20 of the Law defines the levels for planning and execution of the budget and in paragraph 1, items 1 and 2, states:

1) The budgetary cash deficit at the overall state level shall not exceed 3% of GDP at market prices;
2) The public debt shall not exceed 60% of GDP at market prices.

Article 21 stipulates the obligation of the Government that, in case the deficit exceeds a level of 3% of GDP, it shall submit to Parliament within a period of 60 days a suggestion of measures to correct the deficit.

Article 21 also foresees that, in case of a level of public debt, the Government shall undertake the following measures:

1) If the debt reaches a level of 60% of GDP, it shall determine a law on amendments and supplements to the Law on the State Budget, by which the maintaining of the debt within those limits shall be guaranteed.
2) If the debt exceeds 60% of GDP, it shall propose to the Parliament the lowering of multi-year expenditures, the lowering of expenditures towards local governments, as well as propose other measures for the reduction of state debt.
3) If the debt exceeds 60% of GDP because of the realisation of capital projects whose borrowing the Parliament decides on, it shall propose a programme to correct this within a maximum period of 5 years.

Given that the level of public debt has exceeded the level 60% of GDP, the Ministry of Finance, in accordance with the Law on the Budget and Fiscal Responsibility for 2017 prepared a proposed fiscal strategy (2017–2020) which the Parliament of Montenegro adopted in July 2017.

According to the Fiscal Strategy, the following aims were defined:

- The budget deficit has been continuously reduced from 2017 to 2020 and from 2020 is going into the zone of surplus and stands at 4.5% of GDP;
- From 2019, a trend of a reduction of public debt as a percentage of GDP will be established, which in 2020 will amount to 67% and will be 7 percentage points lower than in 2019;
- In the period 2017-2020 the real economic growth will be on average 2.6% per annum;
- Employment is rising at an average rate of 0.9% per annum; and
- Earnings are rising by 1.4% per annum.

This strategy envisaged an increase in excise on cigarettes, an increase in excise on carbonated water with added sugar or other sweetening or flavouring agents, the introduction of excise on coal, an increase in excise on ethyl alcohol, and an increase in the general rate of VAT from 19 to 21 %. The increase in excise was realised during 2017, but excise on tobacco was later returned to the same level.

It is also envisaged that the reduction in the budget expenditures will be achieved through a reduction in the gross earnings fund, a reduction in the basic earnings of 1% (for earnings with a coefficient above 4.1), a reduction in earnings for employment groups A, B and C by 6% (gross effect), and a reduction in expenditures on social benefits and discretionary spending.

It can be said that the strategy has been achieved from the aspect of planned revenues[2], however the current expenditure has already been exceeded. The planned gross earnings in the 2019 budget have been increased in relation to the Fiscal Strategy plan by €42 million in spite of the decision on reducing employment in the public sector, that is, the planned reduction in gross earnings.

1 The Law on the Budget and Fiscal Responsibility ("Official Gazette" 20/2014, 56/2014, 70/2017, 4/2018 – Decision US and 55/2018).

2 According to the report of the Ministry of Finance regarding implementation of Montenegro's budget for 2018, total revenues of €1,746 million were achieved, which is lower than the Fiscal Strategy plan.

Year	Financial strategy plan 2017–2020		Budget plan [3]	
	Current revenues (€ millions)	Current budget expenditures (€ millions)	Current revenues (€ millions)	TCurrent budget expenditures (€ millions)
2017	1538,7	1509	1.534	1.515
2018	1665,8	1513	1.678	1.531
2019	1725,6	1522	1.768	1.630
2020	1778,5	1536	-	-

In a legal sense, we can say that public debt is a credit relationship in which the debtor or borrower is the state, or rather the government. The lenders or creditors, on the other side, are banks, funds, international organisations (such as the International Monetary Fund and the World Bank) and the governments of other countries. Even physical entities may buy government bonds and government notes

The state goes into debt in the form of borrowing, credit and also through financial instruments such as bonds and government notes (as a short-term instrument). Developing countries most often go into debt in order to finance infrastructure projects, such as construction of the traffic and energy infrastructure, schools and hospitals, and the procurement of military equipment. In this way, developing countries lay the basis for future economic growth, which through fiscal earnings will enable repayment of the debt. It is not recommended for developing countries to borrow in order to finance spending, such as on wages and pensions, since they are risking going into a vicious circle of debt and poverty.

An important aspect of public debt is the balancing of the borrowing period of the state's financial obligations arising from public debt with the revenues that the government raises. This is important for carrying out the obligations at the foreseen dynamic, so that the government does not arrive at a state of illiquidity of public finances.

Public debt is divided into external and internal debt. External debt arises towards creditors from abroad, while internal debt is towards domestic creditors. The cost of public debt is expressed through interest expenses, which depends on the interest rate and level of debt. Many factors influence the level of interest rates, first of all the relationship between supply and demand on the financial market and the state's credit rating. In times of crisis, demand for money increases and the supply is lower, so the interest rate, as a rule, grows. Fiscal bodies prefer lower interest rates in order to make borrowing cheaper, while monetary authorities prefer higher interest rates[4] in order to keep inflation under control. The country's credit rating depends on several indicators, such as the amount of current debt relative to GDP, imports, exports, foreign currency reserves and interest payments. Credit risk analysts also take into account the political state of the country, the strength of the institutions, the rule of law, as well as the assessment of the existence of corruption.

From the aspect of financial risks, public debt (not including loans), in cases where a government borrows foreign currency, also implies a currency risk.

Credit risk is effected through the inability of the borrower to perform their financial obligations that are undertaken on the basis of a loan agreement. In that case, the lender faces the risk of losing some of the funds, while the borrower, the state, faces a negative rating, which often prevents borrowing on financial markets.

A currency risk is implied in the case of foreign currency borrowing. If there is a change in the exchange rate while the loan is being paid off and it is necessary to allocate more money for the purchase of foreign currency, then the loan becomes more expensive, which is negative for the debtor. The situation may be reversed when the exchange rate falls in relation to the domestic currency, whereby a smaller amount is required for repayment and the debit becomes smaller. In Montenegro's public debt, currency risk is a dominant part of the motorway loan, as the Chinese Exim Bank funds were approved in euros, while the loan is to be returned in dollars. The contract was concluded in 2014. A fall in the euro against the dollar already occurred in 2014. Since the euro has not yet recovered in relation to the dollar, the loan is now higher than at the time when it was agreed. The risk effects will only be clear at the beginning of repayment of the loan in 2021 (depending on the relationship between the euro and the dollar in the repayment period).

In the analysis we have followed the dynamics of public debt in the period since 2006, when Montenegro gained international recognition. We have attempted to look at the issue of public debt from multiple angles – the parameters of public consumption, revenues and expenditures, as well as other economic parameters, such as average earnings, foreign direct investment, imports and exports.

THE STATE COLLECTS MORE THAN IN 2006 AS A PERCENTAGE OF GDP

Current revenues under the Law on Budget and Fiscal Responsibility include: taxes, contributions, fees, charges, concessions and other revenues. Current revenues are relevant to the analysis, as they represent the funds that the state

3 Marina Ralašić, "Javni ili državni dug". Financijska praksa. ["Public or State Debt". Financial Practice] 17 (4), 381-383.
4 Marina Ralašić, „Javni ili državni dug". Financijska praksa, 17 (4), 381-383

takes from industry, enterprises and citizens for the purpose of financing public spending. In addition to the current revenues, the state also has revenues from the sale of property, loan repayments, donations and debt.

Based on the data from the DRI's (State Audit Institution) annual report on the final budget account for the period 2006–2018, current budget revenues amount to €14.06 billion. In addition to the €2.45 billion increase in public debt, Montenegro also recorded €6 billion in foreign direct investment in the period 2006–2017. If we take 2006 as the base year, in the context of gaining independence, we see that in 2017 the state collected much more money in relative terms than it did back then. In 2006, current revenues amounted to 25% of GDP, while in 2017 they amounted to 35%. With the higher spending relative to GDP, the state has also increased its public debt by a factor of 4.2. The question is – to what extent has the increased public spending had the effect of increasing the quality of life in Montenegro? We can also ask the question: to what extent have the sector policies become more effective? Has education increased in quality or are we talking about a fall in its quality? The health system was ranked among the worst in Europe a few years ago. The aspect of the inclusivity of the economic growth is also being raised, considering that in 2006 the unemployment rate was 29%, while in 2017 it was 22.29%. The inactivity rate of the population is high and amounts to as much as 42.4%. In the period since the crisis in 2009, there has also been a significant increase in poverty.

Table 1. Dynamics of public finance relative to GDP

Year	Current budget revenue (€ millions)[5]	Changes in the amount of current revenues (%)	GDP[6] (€ millions)	Nominal GDP growth rate (%)	Current budget consumption[7] (€ millions)
2006	562		2170		510
2007	790	40	2689	23,9	645
2008	1.307	65	3103	15,4	1133
2009	1.146	-12.3	2994	-3,5	1277
2010	1.135	-1	3125	4,4	1273
2011	1.124	-1	3265	4,5	1292
2012	1.115	-0.8	3181	-2,6	1260
2013	1.228	9.5	3362	5,7	1359
2014	1.339	9	3458	2,8	1322
2015	1.312	-2	3655	5,7	1361
2016	1.470	12	3954	8,2	1515
2017	1.534	4.3	4299	8	1515

As is shown in Table 1, only two years were recession years – 2009 and 2012. The current revenues did not follow the dynamics of GDP growth despite rises in taxes, such as VAT growth – from 17% to 19% (in 2013) and finally to 21% (in 2018). Excise on broad consumer goods such as petroleum derivatives was also increased. The fact that the growth in current revenues has not always followed the growth of GDP, as an expression of the tax base, can have two causes: inefficient revenue collection by the tax authorities, or an overestimated GDP. Attention should also be paid to the growth in GDP over the period 2014–2017, when it increased from €3,458 to €4,299 million, which is a rise of 24.5%. Is it realistic that Montenegro increased its GDP in nominal terms by one-quarter, given that the inflation rates were not high? According to the Central Bank of Montenegro reports, the average inflation rate (measured by the consumer price index) in 2017 was 2.4%, in 2016 it was 0.3 %, while in 2015 it was 1.5%. In the same period, 2014–2017, China increased its GDP by 17%.

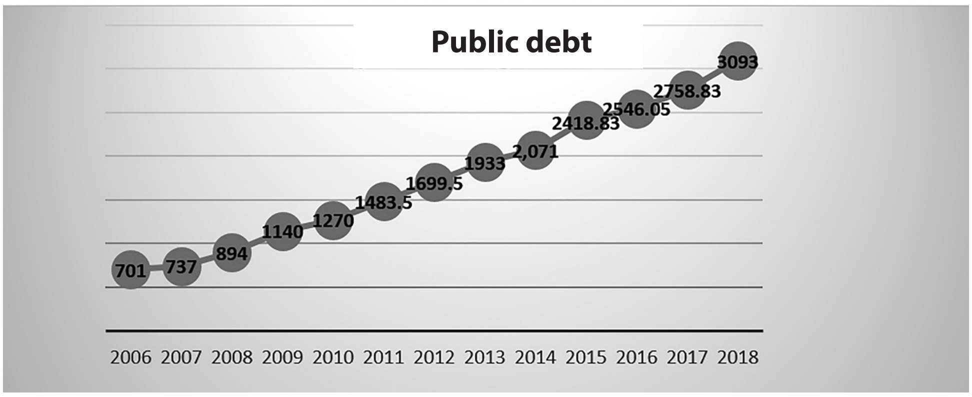
5 Source: Annual Report of the State Audit Office on the Draft Budget Final Account for the Period 2006–2017.
6 The data on the level of GDP and nominal growth are based on MONSTAT's announcements.
7 The current spending budget column for the period 2013–2017 is taken from the table of the DRI's Annual Report on the Proposed Final Account for 2017 (p. 14). For the period 2006–2012, the current consumption is derived from the DRI's annual report on the proposal of the final account of the budget, as well as from the final accounts of the budget of the Ministry of Finance.
The current budget spending is used in practice for showing public spending, which is related to the fiscal year. The current budget spending implies budget expenditures less the capital budget and debt repayments. The current expenditure items are: current expenditures (gross earnings and contributions at the expense of the employer, other personal incomes, material and service expenses, current maintenance, interest, rent, subsidies and other expenses), social security transfers, transfers to institutions, individuals and the public sector. Sometimes borrowings and credit items, as well as budget reserves, are shown in the current spending budget or else are shown separately.

Table 2. The relationship between capital investments and borrowing (in € millions)

Year	Realisation of capital budget [8]	Publuc debt[9]			State aid[10]	Paid guarantees[11] (€ m)[12]	Motorway[13]	
		End of year (€ m)	Annual increase (€ m)	% od GDP			Realisation	Loan
2006	31,6	701		38,3	65,4	1,050		
2007	31,8	737,2	36,2	32,4	24,8	-		
2008	73,3	894	157	26,8	45,8	0,052		
2009	112,3	1.140,2	246	37,0	50,5	1,76		
2010	63,2	1.270,7	130	42,0	71,7	-		
2011	67,1	1.483,5	213	45,3	66,4	33,91		
2012	58,7	1.699,5	214	50,91	41,8	24,72		
2013	77,2	1.933	234	57,95	100,301	107, 23		
2014	75,89	2,071.71	138	59,91	28,032	15,26		
2015	238,42	2.418,83	347	66,18	23,37	-	174,65	137,62
2016	77,28	2.546,05	128	64,39	20,71	-	15,80	7,89
2017	274,06	2.758,83	212	64,17	19,741	-	184,92	149, 86
2018	264,7	3.152,9	394	68,26		-	165,2	
∑	1.445	2.876[14]		62,27	558	183,98		

The Law on the Budget and Fiscal Responsibility, in Article 4, defines the capital budget as a "plan relating to a one-year period or a period longer than one year in which the value of non-financial assets are increased, and this includes the acquisition of infrastructure, construction facilities, land and equipment of public or general interest (at the state or local level)". In the table above we have presented the level of the capital budget in the observed period from 2006 to 2018 in order to compare the level of debt with investment in capital projects.

Figure 1.



8 Source: Annual Report of the State Audit Office on the Proposal of the Final Account of the Budget for the Period 2006–2017.
9 Source: Ministry of Finance Report on the State of Public Debt at the End of the Year.
10 This data is taken from the State Aid Control Report for the Period 2006–2017.
11 Source: Annual Report of the State Audit Office on the Proposal of the Final Account of the Budget for the Period 2006–2017.
12 The guarantees paid are integrated into funds that are set aside for state aid. The guarantees are given here for greater clarity.
13 The data on the financial implementation of the motorway project for the period 2015–2017 is taken from DRI reports, while the data for 2018 is taken from the Ministry of Finance's Budget Realisation Report for 2018.
14 State debt less deposits.

Figure 2.

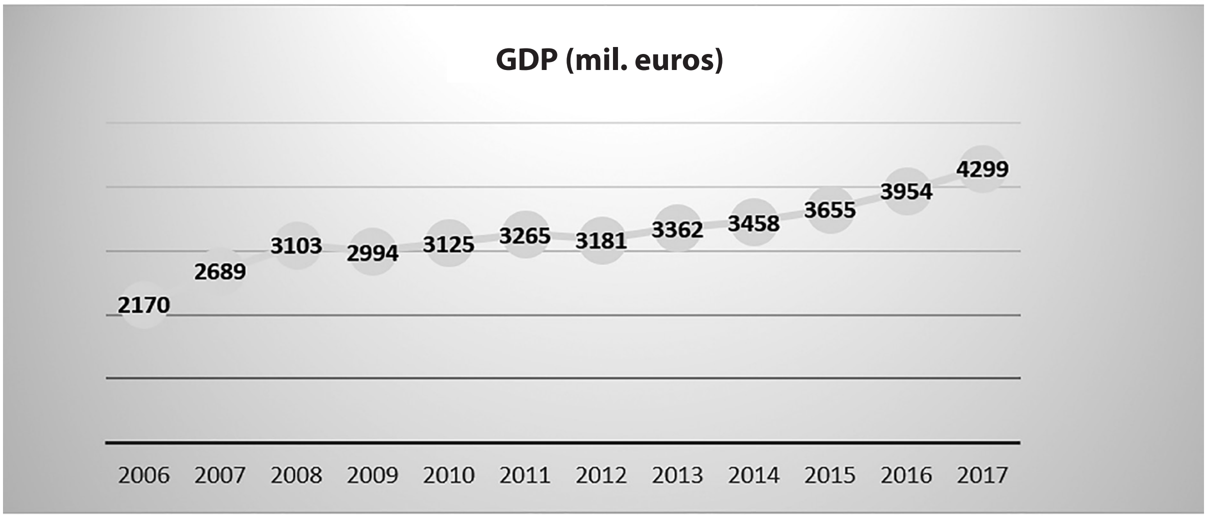
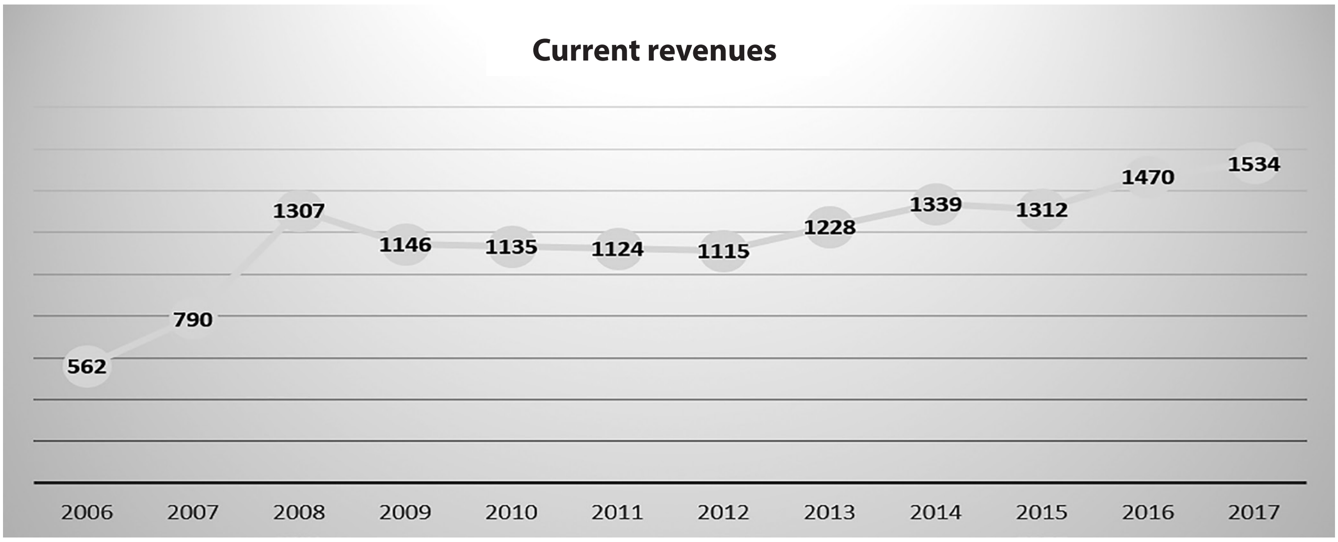


Figure 3.



TIn the post-crisis years the current revenues grew at a slower pace than GDP as an expression of the tax base despite tax rates and excises increasing.

The initial level of public debt in 2006 was €700 million. Since then public debt has increased by €2.45 billion. The funds from public debt have been used to finance current budget spending and capital budget. The capital budget breakdown for the period 2006–2018 amounted to €1.45 billion. If we proceed from the assumption that the borrowing was justified for the financing of the capital budget, i.e. investment in infrastructure, then we can say that the total sum of capital budgets in the period 2006–2018 "justifies" 59 percent of the debt arising since 2006. Also available for the financing of the capital budget was disposable income from the sale of assets, which according to the DRI in the period 2006–2018, amounts to €197 million.

It should be said that the tax debt has also been written off through state aid, whereby the budget has in this way been deprived of potential income, which has been substituted for through borrowing. The public debt has steadily increased. Its growth is faster than other macroeconomic parameters such as GDP and current budget revenues, or average revenues at the state level. This indicates that public debt and foreign direct investment are "generators" of economic growth. However, such growth has its own natural limits, such as the already achieved public debt level, or the limitation of FDI to spatial resources and the construction sector. Public consumption also affects the growth of GDP. To determine the impact of public spending on GDP growth, a fiscal multiplier is used. This indicator shows how much one monetary unit spent on expenditure affects GDP growth. The fiscal multiplier may be larger than one, which means that every euro spent on GDP spending will grow by more than €1. It can be under €1 thus the euro in consumption will reflect the GDP growth in the value of less than 1€. The fiscal multiplier can also be negative when increased consumption reduces the

GDP. We have no fiscal multiplier data in Montenegro but we assume that it is not high and it probably varies between 0 and 1 since we don't have developed reproductive chains. So the euro used in consumption is used for payment of goods and services from export while the turnover in domestic economy is not high [15].

The coverage of import by export is only 17%. The economy is poorly diversified, the industry is underdeveloped, while development is mainly focused is on agriculture and tourism. It is emphasized that tourism accounts to 20% of GDP. However, it is widely held that the optimal share of tourism in the GDP should be around 5%. High share of tourism in the GDP tells how bad the things are in other sectors of economy. (For example, last year's share of tourism in Italy's GDP was 2.2 %, in France 1.9% and Spain 4.7%)[16].

Montenegro suffered the worst recession in the region in 2009 even though in the years after the referendum on independence the economy's growth was praised as a miracle with forecasts of at least another decade of high rise of Montenegro's economic eagle. Thanks to foreign direct investments the budget revenues were growing in 2007 and 2008. The FDI generated demand and filled the budget, mainly through VAT collection.

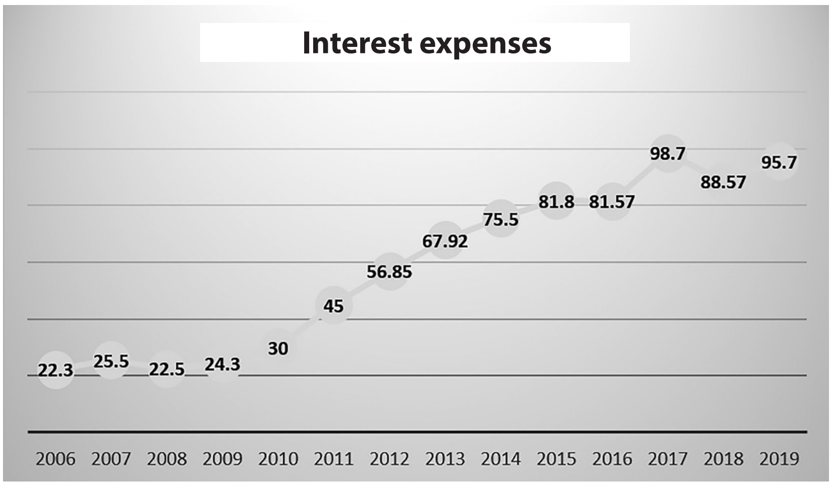
In 2006, the level of consolidated public spending amounted to €884 million. Only two years on, the consolidated public spending[17] amounted to €1.5 billion. Compared to 2006, it grew by almost 70% [18]. When you increase the public spending you have no resistance if you have low fiscal burdens. However the resistance always comes to the fore when consumption decreases. That suggests that this is not a flexible policy instrument, and every increase must be accompanied by careful sustainability study [19].

Table 3. annual interest expense

Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total
interest expense in € m	22,3	25,5	22,5	24,3	30	45	56,8	67,9	75,5	81,8	81,5	98,7	88,5	95,7	816,2

Source: Annual Reports of the State Audit Institution on the final budget proposal for 2006-2017. Data for 2018 - 2019 are presented on the basis of budgetary projections of the Ministry of Finance.

Figure 4.



Annual interest expenses were growing by the year and reached the amount of almost €100 million. If we take into account that the budget of Podgorica City Council is €65 million, we can conclude that interest expenses account for 150% of the city's annual budget. The IMF warns of the unsustainability of the concept where the share of expenditures for interest rates outpaces the nominal economic growth of the GDP, especially in countries that refinance debt.

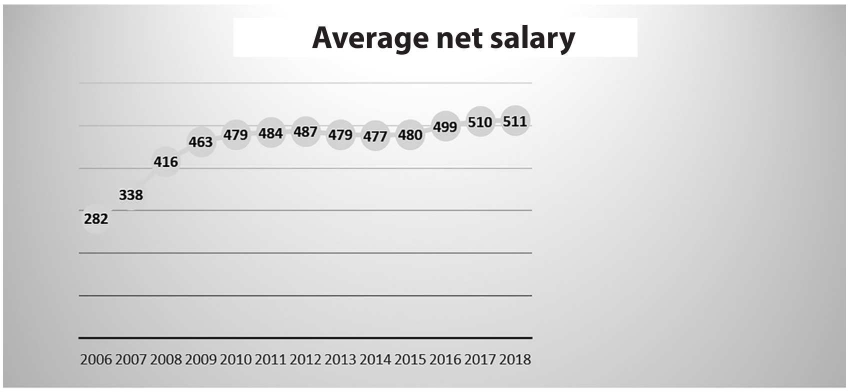
15 See Helena Gadže – „"Fiscal multiplier"- Finance Club (www.finance.hr). (2016)
16 Goran Rihelj, „"Last year the tourism industry grew by 10% which accounts to 19.6% of GDP", hrturizam.hr
17 Consolidated expenditure implies the spending on the national and municipal levels
18 Consolidated expenditures data were copied from the Final Budget Account of Montenegro for 2006 and 2008.
19 Zarija Pejović, "Socio-economic challenges of Montenegro" – Matica Crnogorska, No. 65, 2016.

Table 5: average net salary

Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
average net earnings	282	338	416	463	479	484	487	479	477	480	499	510	511
annual earnings change		19.9	23.1	11.3	3.5	1.0	0.6	-1.6	-0.4	0.6	4.0	2.2	0.4

Source: Monstat

Figure 5.



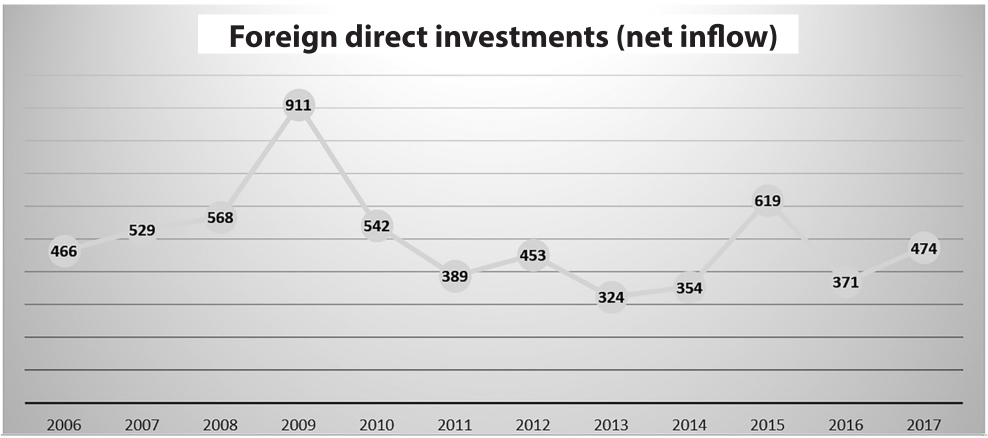
As the graph above shows, the average net salary stagnates. Since 2009, it has increased by only €50. Since the previous decade saw economic growth (only 2 years suffered recession- 2009 and 2012) the fair GDP distribution is matter of concern. Having in mind the steady growth of public debt we face a dilemma on who benefited from the borrowing? More levies were introduced, such as higher VAT and excise,which led to reduced real wages. On the other hand, the state did not increase capital taxes, such as the profits of legal entities. Thus we can say that labour was rather taxed than the capital. Although we have noted that GDP in the period 2014-2017 increased by 24.5% the average wages increased by 7% in the same period. That again questions how fair was the estimate of GDP level.

Table 6. Foreign Direct Investment (net gain)

Years	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	∑
FDI in € millions	466	529	568	911	542	389	453	324	354	619	371	474	6.000

Source: Central Bank of Montenegro Annual Reports (2006-2017)

Figure 6.



Foreign direct investments are drivers of economic growth. As we can see from the graph, FDIs are volatile, which means they change at unpredictable rate thus making it difficult to project their impact on public revenues.

THE INFLUENCE OF PUBLIC DEBT INTEREST RATES ON THE INTEREST RATES IN ECONOMY

Relatively high public debt interest rates also affected the interest rates of loans granted by Montenegrin banks to businesses and citisens. Although the interest rates in Europe went down and even reached new lows due to the European Central Bank measures, the interest rates for government borrowing were relatively high. In banking theory the government borrowing is considered the least risky and as a consequence the interest rates are low. However the credit rating of Montenegro, according to rating agencies, is low and belongs to the speculative zone which implies a high credit risk thus increasing the cost of borrowing. High interest rates at which the state was borrowing, also had an impact on the economy and the population as borrowers so the active interest rates in our banking sector have remained high. The Central Bank appealed to commercial banks

banks to lower the interest rates and approved the opening of new banks vainly hoping that competition would bring the rates down.

PUBLIC DEBT RISKS

If the state is poor, there is a risk that creditors will not approve the loan for the infrastructure projects.

Such countries are "condemned" to poverty, as is the case with some African countries. If the state succeeds though, there is another risk that the loan funds will not be efficiently used, and that future revenues will not be sufficient to service the loan [20]. Failure to fulfill the obligations to the creditors puts the state at risk of default. It is therefore important to avoid borrowing to feed consumption but to focus on investments that will the driving force of development. The Nobel Prize winner Michael Spence [21] in his article "Growth in Time of Disruption" published in the Project Sindicate states: "... problems in advanced countries - from slowed economic growth to political uncertainty - are likely to take time, reducing potential growth everywhere over a longer period. In this context, developing countries must not be tempted to try to stimulate demand through unsustainable assets, such as the accumulation of excess debt". In the same text, Michael Spence also recommends developing countries to implement infrastructure projects through financial arrangements with international development financial institutions. The Government of Montenegro did not act in that manner during the highway construction and in the 2019 Munich Security Report it is stated: "A loan of €809 million for the construction of the first section of the highway to Serbia has led to an increase in the debt of Montenegro to unsustainable 80% of GDP, which has caused widespread concern that Beijing will subject Montenegro to *diplomatic borrowing*".

When a country defaults on its debt, further borrowing is disabled, so the governments of those countries, as a rule, turn to the IMF for loans whereby they can service the debt. On the other hand, the debtor is obliged to save money in order to deal with the debt. However, austerity measures reduce consumption, which has a negative impact on economic growth and the economy enters recession. Paradoxically, the measures make the debt-to-GDP ratio worse instead of improving it. Due to GDP fall. The austerity measures also affect the quality of life of citisens through reductions in salaries, pensions, health-care and education system. Economies find themselves in a vicious circle in which striving to repay public debt through savings brings the economy into recession and further into political crisis. Now how far the state can go without defaulting depends on its fiscal capacity, the state of economy and political situation. Certainly, the higher the level of public debt relative to GDP, the greater the risk. The following table is given the debt-to-GDP ratio frequency at the time of default.

Table 7.

External debt at the time of default: distribution of frequencies 1970-2008

The ratio of external debt-to-GDP at the end of first year of default or reprogramme	*Percentage of total number of defaults or reprogrammes in the mid-income countries*
< 40	*19,4*
41-60	*32,3*
61-80	*16,1*
81-100	*16,1*
>100	*16,1*

Source: Caren Reinhardt, Kenneth Rogof. "It's Different This Time" JP Official Gazette, 2011. (pg. 68) [22]

20 Jeffrey D. Sachs. "The Age of Sustainable Development". Cirsd, Official Gazette (2014) In Chapter 4, the author explains why some countries are developed and some are poor.
21 A. Michael Spence (born 1943, Montclair, New Jersey, USA), an American economist who with George A. Akerlof and Joseph E. Stiglitz in 2001 received Nobel Prize for Economics for Market Theory with Asymmetric Information.
22 Caren Reinhardt, American economist, professor at Harvard Kennedy School, Contributor to the International Media Project Sindicate.
Kenneth Rogof, US economist, former chief economist of the IMF, economics professor at Harvard University.

Although Montenegro is not a member of the European Monetary Union, dollarisation has already been made, by accepting the euro as official currency. As a country in the process of EU accession, Montenegro should follow the Maastricht criteria, which require a debt-to-GDP ratio up to 60%. The Mastrian criteria, however, has been violated since the ratio stood at 68.26%. If based on the previous figures we take a look at Montenegro's risk of default in Table 7, the cumulative probability at the level of public debt-to-GDP of 68.2% ranged from 50 to 67%[23]. However there are countries with strong economies and a high level of foreign exchange reserves that can withstand high public debt, as is the case of Japan (where this ratio is over 200%)[24]. Economists Reinhardt and Rogof warn that intolerance to debt in developing countries already faces a threat on the level of 30 to 35% of GDP. Authors Reinhardt and Rogof also state: "Debt intolerance is a syndrome in which weak institutional structures and a problematic political system make external borrowing an appealing asset whereto the government can resort so to avoid difficult decisions on expenditure and taxation ". [25]

In addition to the public debt ratio with GDP, it is also important to consider the relationship between public debt and exports, which is one of the sources of foreign exchange income. In Montenegro, the coverage rate of import by export is very low and amounts to only 17%. If we compare the total exports of Montenegro, which, according to the Monstat data, amounts to €371 million in 2017, with the public debt of €3.1 billion, we come to the ratio of 11%. This relationship comes to light when compared with the countries of the region.

Table 8. Comparative Indicators- countries of the region

Country	public debt in € billions-2018	exports in € billions -2017	export/ import % -2017	public debt/GDP %	annual export /public debt %
Montenegro	3,1	0.37	16,1	70,1	11
Serbia	23,5	15	77,4	59,6	63
Macedonia	7,4	5,1	73	38,7	68
Albania	8,1	1,98	39	69,9	24
Bosnia and Herzegovina	5,8	5,8	61	35,6	100

(The indicators in the table were collected by search on Internet and should be taken as approximates as those are variable economic indicators)

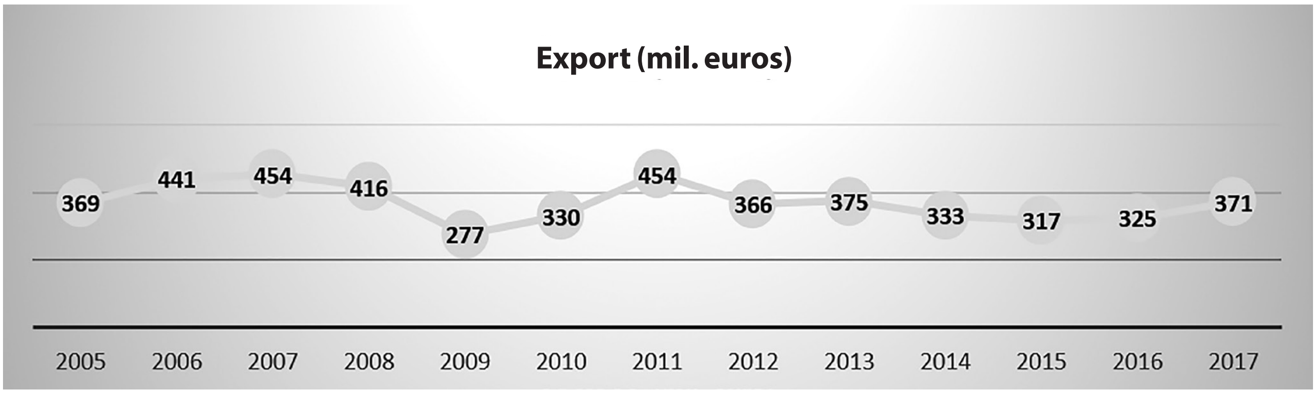
23 If we assume that at 100% probability, all cases of defaults by countries for the frequency given in the table, at the ratio of public debt-to-GDP of 70%, defaults occurred in 50 to 67% of countries.
24 Source: http://worldpopulationreview.com/countries/countries-by-national-debt/
25 Karen Reinhardt, Kenneth Rogof. "This time is different" JP Official Gazette, 2011 (page 64)

Table 9: Foreign Trade of Montenegro

Year	imports (€ thousands)	exports (€ thousands)
2005	1,042,828	369,321
2006	1,457,350	441,133
2007	2,073,085	454,739
2008	2,529,736	416,165
2009	1,654,162	277,011
2010	1,657,326	330,367
2011	1,823,330	454,381
2012	1,820,850	366,896
2013	1,773,352	375,585
2014	1,784,214	333,166
2015	1,841,524	317,172
2016	2,061,688	325,846
2017	2,303,000	371,100

Source: Monstat

Figure 7.



Montenegro has a dramatically low coverage of imports by exports. Export-to- total debt ratio is also low unlike other countries of the region. Export can also be viewed as a statement of the overall public policies of a state, ie it shows competitive ability of the economy on the international market. Current exports of Montenegro are mainly raw materials and semi-finished products (wood, stone, aluminum ingot ...). Raw materials and semi-finished products, as a rule, have floating prices on the international market. The economies with this export structure are exposed to external shocks which reflect on demand and income. In that context the economy of Montenegro found itself in recession in 2009, despite record foreign direct investments worth €911 million. Furthermore tourism also has an effect of export, through the consumption of domestic products by guests.

It is interesting to note that Montenegro's export has even decreased compared to the period of 10 years ago. Serbia has increased its export from 2013 by 33%. According to the EU Delegation in Serbia, the exports to the EU have more than tripled (€3.2 billion in 2009 and €9.9 billion in 2017).

Macedonia was considered less developed than Montenegro in the former Yugoslavia. Now Macedonia's export is growing with solid coverage of imports by exports. Several "Technological Industrial Development Zones" (TIRZ) have been opened in Macedonia, which are

intended for investors. Although Macedonia has received less FDI than Montenegro, it has created more than 100,000 jobs, thus cutting unemployment from 36% in 2006 to 20.8% in 2018.

In Montenegro the structure of the employees has been changed since transition. The jobs in real economy have decreased while the administration has been enlarged.

It can be concluded that the countries of the region actively implement the policies aimed to attract foreign direct investments. Montenegro has seen no significant investments in the production sector. Investments go to tourism, construction and real estate sectors.

However, even though tourism is given priority we can not say that it is a job creating industry which employs highly educated and skilled. The labour force is mainly brought from the countries of the region.

SOLUTION TO PUBLIC DEBT

Upon government proposal, the Parliament of Montenegro adopted the Fiscal Strategy for the period of 2017-2020. According to the Strategy, the current budget spending by 2020 should be maintained at the level of €1.5 billion. Since we still don't have the final budget account for 2018, we do not know how much the public expenditures fare in relation to the Fiscal Strategy.

The 2019 budget plan stands at €1.63 billion, which is €108 million more than initially envisaged by the Strategy [26]. Current revenues, according to the fiscal strategy, have been increased and stand at €1.7 billion according to projection for 2019. The Fiscal Strategy envisages the increase of revenues in the to €1.8 billion in 2020. We can say that the Strategy is successful in terms of revenues while the new levies have pushed the social sustainability to the edge. It's possible to increase budget revenues through widening the tax base and GDP growth. In order for public revenues to reach the level needed for servicing and gradual reduction of the public debt, it is necessary to attain to the level of at least €1.9 billion of revenues, provided that the current expenditures remain at €1.5 billion. Thus when the current consumption is taken care of, the remaining funds of €200 million would be used to reduce debt, while the capital budget would be financed with another €200 million. The risks we face here are the sustainability of GDP growth which is predominantly generated by FDI and borrowing. FDI go to real estates and construction thereby generating demand and increase revenue through VAT. Moreover the highway project financed by China's Exim Bank generates demand and consequently helps the GDP. However, FDI is prone to unpredictable changes, as can be seen from Figure 6, and the possibility of further borrowing, except for debt refinancing, is limited. So we come to the issue of sustainability of the economic growth and how successful have been the policies and investments so far. As for the public debt structure, the Eurobonds account for more than a third of the total debt - €1,217 million. The Eurobonds are not the best way of borrowing as their repayment is such that in the years of maturity of the bond interest is paid, while in the last year the original is returned plus the interest. The government has to accumulate the funds for the last year and pay interest in the meantime.

Montenegro did not manage to realise all Eurobonds in 2016. That pointed to distrust among investors when it came to the country's creditworthiness. However, thanks to the IMF and the World Bank support, primarily through positive reports on the state of national economy and through the WB guarantees, the government has continued to borrow and refinance the existing debt. It can be said that Washington's political will is crucial in maintaining the liquidity of public finances. Figuratively speaking, Washington, in the present geopolitical constellation, "keeps Montenegro's public finances above the water level".

26 According to the Fiscal Strategy for 2019, the planned expenditures for gross salaries amount to €430 million, while in the budget draft for 2019 the figure is €472 million. This increase in gross wages is indicative given the government's decision to suspend further job creation in the public sector in 2018.

STATE AID - CASE STUDY OF PODGORICA ALUMINUM PLANT (KAP)[27]

Tabular overview of write-offs and deferred obligations of KAP upon government decisions 28

legal base	Amount (€)
profit tax (incl.penalties) in 2006 and 2007	8,000,000.00
tax due (31 July 2008- 31 July 2009)	2,000,000.00
KAP's debt to government (annex 12 of the privatisation contract)	75,239,909.01
adjustment for electricity costs No 02-8819 and 02-9898	6,065,371.93
state guarantees to KAP	135,000,000.00
social welfare programme	5,000,000.00
electricity subsidies in 2009-2012	15,000,000.00
	20,000,000.00
	18,000,000.00
	7,000,000.00
deferred obligations to government (salary tax and contributions) in 2009	8,800,000.00
assumption of debt –Montenegro Bonus Cetinje LLC for customs fees including 6% interest	1,512,301.37
Total	**301,617,582,31**

The total state aid to the Podgorica Aluminum Plant (KAP) amounts to €301 million, which represents 10% of the country's total public debt and 6 times the price paid for KAP by the former KAP owner- Salomon Enterprises Limited (later renamed the Central European Aluminum Company-CEAC). KAP was privatised in 2005. In addition to the price for KAP shares of €48.5 million, the new owner had a contractual obligation to invest €55 million in production capacities within five years since the contract. The State Audit Institution (DRI) noted that the buyer in the period prior to issuing of state guarantees, did not fully meet its contractual obligations. That could have been one of the reasons to terminate the 2005 contract. The government, when issued guarantees for CEAC, protected itself by counter-guarantees "with a total nominal value of €22,185,131.14, which was 16.85% of the total state guarantees issued to KAP (if the shares were sold at nominal value) ". KAP's financial restructuring programme did not envisage further development of downstream production and had in store to lay off 1,035 employees, or half of the total labour force. Experts in the field of technology and economics believe that KAP's downstream production could have made the company profitable. With proper management and investments in modernization of KAP's facilities, the export of Montenegro would have been significantly higher and consequently the budget revenues.

The procedure for issuing guarantees to KAP had significant shortcomings, which is stated in the conclusions and assessments of the State Audit Institution (DRI) as stated in the Government Guarantees Issued By The Government of Montenegro in 2010 and 2011":

1) The entities [29] did not sufficiently implement the prescribed normative procedure for giving state guarantees for KAP loans.

2) The entities did not present their own analyses of the financial position of KAP, the analysis of the economic sustainability of the KAP Financial Restructuring Programme, while the credit risk assessment and an appropriate cost-benefit study are lacking, as well as assessment of potential consequences to the state budget, upon activation of the state guarantees to KAP. The audited entity stated that it had no legal obligation to produce these documents".

27 The study is based on the data and conclusions of the State Audit Institution – "Report on the Revision of State Guarantees Issued in 2010 and 2011 " (published in 2013).
28 State Audit Institution - "Report on the Audit of State Guarantees Issued in 2010 and 2011", p. 18.
29 The entity of the audit is primarily the Ministry of Economy as the provider of state aid, then the Ministry of Finance, the State Aid Commission, the Government of Montenegro and KAP as a state aid beneficiary (commentary by the author of the analysis).

3) The facts presented in the financial statements of KAP and the reports of commercial auditors were warnings that KAP had "accumulated losses, that it was too much in debt and that very likely it could repay the loans".

4) The 2009 settlement agreement shows that the Government's decision to issue state guarantees for KAP loans of up to €135.000.000 (issued €131.680.000) without appropriate counter-guarantees posed a severe risk.

In the aforementioned audit report, DRI also noted the following:

The audit found that state aid providers did not timely submit report data to the State Aid Commission. That shows that:

- the state aid providers had no efficient supervision of the beneficiaries;
- The Government of Montenegro has not been informed in a timely manner whether the given state aid is appropriately used.

The state auditor is not convinced that the State Aid Control Commission conducted direct control of the proper use of funds.

RECOMMENDATIONS:

1. It is recommended that the Government, ie. the Ministry of Finance, follow the guidelines of public expenditure determined by the Fiscal Strategy of 2017. It is necessary to limit the current budget spending to €1.5 billion. The original budget revenues should grow up to €2 billion by 2020. Then from €200 to €300 million should be accumulated each year to serve for debt repayment. The rest of the difference between revenues and current budget expenditures, coupled with funds intended for repayment of debt, should be used for the capital budget. Since the amount of revenue will depend on the fiscal base, ie. the GDP growth, it is important to limit expenditures.
2. According to the "Medium-Term Public Debt Management Strategy 2018-2020" prepared by the Ministry of Finance, it is proposed that public debt management has greater reliance on domestic sources of financing . It should be kept in mind that "drying up" of the domestic financial market can lead to a deterioration in the borrowing conditions of the local economy and population. It is therefore necessary for the Government to plan the debt level in the domestic market that will not jeopardize the borrowing conditions of domestic borrowers.
3. Neither the government nor the Parliament should support the non-selective fiscal rates which are almost by default at the expense of work. Perhaps it could be possible to increase the rate of corporate income tax, which is low and stands at only 9%.
4. It is necessary for the Ministry of Finance to conduct a study of the impact of a possible arrangement with the IMF on public expenditures, which would involve the withdrawal of money for the refinancing of public debt. IMF's money has a significantly lower interest rate than the market rate. That would reduce the interest expenses. Montenegro's debt level was low up to 2006 due to advisory arrangement with the IMF.
5. The government should create an environment for re-industrialisation, as well as for innovative policies aimed at raising the competitiveness of the national economy, and become more appealing to foreign direct investments in the field of manufacturing. The goal is to open new companies, increase exports, create new jobs, and thus generate more public revenues.

dr Zarija Pejović

CONCLUSIONS

1. Montenegro's public debt has grown since independence in 2006 from the initial level of only €701 million to €3,152.9 million in Dec 2018, according to the Ministry of Finance reports. The average weighted interest rate of debt is 3.1%. The average maturity of external debt is 4.5 years, while the internal debt's maturity stands at 5.2 years [30].

2. The structure of borrowing instruments is unfavorable, as Eurobonds account for 39% of public debt. The money raised by issuing bonds serves only to pay interest expenses, while in the year of maturity the original is given back plus the annual interest, which is a heavy weight on public finances. It is particularly risky that the amount of €1,160.4 million is due for payment in the period of 2019-2021 [31].

3. Public revenues are still insufficient to finance current consumption and repayment of debt which has to be refinanced. Fiscal levies have been increased to the point of social sustainability. Therefore the future growth in public revenues will depend on the economic growth. The fiscal strategy has envisaged a surplus as of 2020. However the plans are not implemented when it comes to expenditures because of rising consumption. That will affect the plans for public debt reduction as of 2019, as it had been envisaged by "The Fiscal Strategy of Montenegro (2017-2020)" and "The Medium-Term Public Debt Management Strategy (2018-2020)".

4. The interest expenses will have exceeded €800 million in the period from 2006 to the end of 2019, which has a negative impact on a small dollarised economy such as Montenegro is which will deprive the country of funds which could support investments.

5. Montenegro's credit rating is low. Moody's rating is B1, Standard & Poor's is B+/B. Therefore the loans granted to Montenegro are considered high risk and speculative grade.

6. The logic that borrowing is justified so to finance the capital budget is in collision with available data. From 2006 to the end of 2018, the sum of capital budgets amounted to €1.45 billion, which is 59 % of the debt generated in the same period. The question is how much the investments were effective, in terms of choosing those projects that would cause the best growth and development. The success of investment is also questionable in terms of whether the infrastructure projects have been implemented in the most rational way, financially speaking. Public debt is also used to finance current budget expenditures including the state subsidies. The largest part, some €300 million, was used for Podgorica Aluminum Plant (KAP).

7. Montenegro's export is low, which is a sign of the economy's lack of competitive edge abroad despite the public debt growth by €2.45 billion and €6.3 billion of foreign direct investments (FDI) in the period of 2006-2018, according to Monstat reports. The State Audit Institution (SAI) reports the budget revenues of €14.06 billion in the same period. The fact that such high accumulation of funds has not led to rising exports, manufacturing in particular, points to the weakness of state institutions.

30 Ministry of Finance "Medium-term Strategy of Public Debt Management 2018 -2020", March 2018.
31 Eurobonds amount to €1.080 million while domestic bonds stand at €80.4 million.

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