Country Economic Memorandum

Towards a New Growth Model

May 24, 2013
The World Bank
Roadmap

- **Sustainability**
  - Sources of growth
  - Ensuring fiscal and financial sustainability
  - Towards a new growth model
- **Flexibility**
  - Investment climate survey
  - Doing business in Montenegro
  - Product market regulations
  - Labor market regulations
- **Policy recommendations**
Sources of Growth

Domestic-demand driven, robust pre-crisis growth...

...led by factor accumulation rather than increases in TFP.

Demand-Side Sources of Growth in Montenegro, 2000-10

Factor-Input Sources of Growth in Montenegro, 2000-10

Sources: MONSTAT and World Bank staff calculations.
Production shifted from agriculture, mining, and manufacturing towards construction and services...

Sources: MONSTAT and World Bank staff calculations.
...while education had a significant impact on growth

### Contribution of Education and Knowledge to Growth in Montenegro, 2000-10

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<tbody>
<tr>
<td>GDP</td>
<td>5.0%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Capital</td>
<td>2.9%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Uneducated labor force</td>
<td>0.8%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Retaining existing educational level of labor force</td>
<td>0.6%</td>
<td>0.4%</td>
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<tr>
<td>Improvement of educational structure</td>
<td>0.9%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Advance of applied (technical/vocational) knowledge</td>
<td>-0.2%</td>
<td>-1.1%</td>
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Sources: MONSTAT and Popovic and Madzarevic-Sujster (2012).
Ensuring Fiscal Sustainability

Fiscal policy has been mostly procyclical which built up high public debt...

...highly sensitive to any shock.

Notes: Contingent liabilities’ shock assumes a one-off assumption of total guarantees in 2013. Growth shock assumes 0.2 percent average growth for 2013-2015. The baseline scenario follows the Government’s budget scenario, which assumes 2.5 percent growth in 2013 and the pick-up thereafter.

Sources: CBCG and MoF, and World Bank staff calculations.
Ensuring Financial Sustainability

Credit boom and bust increased nonperforming loans, making banking system vulnerable

Credit Growth, percent

Nonperforming Loans, percent of total loans

Sources: CBCG and SEE Regular Economic Report
Montenegro’s New Growth Model

Largest gaps in competitiveness are in technological readiness, labor market efficiency, higher education and innovation.

Pillars of the Global Competitiveness Index, 2012-13

Score: 1-7 (best)

Institutions

Innovation

Infrastructure

Macroeconomic environment

Health and primary education

Higher education and training

Goods market efficiency

Labor market efficiency

Technological readiness

Financial market development

Market size

Business sophistication

Score: 1-7 (best)

Montenegro

Balkans (excl. Kosovo and Montenegro)

Croatia

EU10

EU15

New growth model needs to involve public sector institutions and the rule of law.

Source: World Bank
Does Higher Growth Matter?

With an annual 2.4% growth in total factor productivity, PPP adjusted GDP per capita reaches the level of EU27 in less than 50 years.

Sources: EUROSTAT and World Bank staff estimates.
Investment Climate Survey Insights

- Enterprise survey designed by the WB, comparable with other Business Environment and Enterprise Performance Surveys (BEEPS)
- Tries to identify barriers to business growth and investment
- MICS and BEEPS measure how constraints are perceived and ranked by businesses

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<tr>
<td><strong>Average Severity:</strong></td>
<td></td>
<td>Rank:</td>
</tr>
<tr>
<td><strong>0-4 (most severe)</strong></td>
<td></td>
<td>1 (top constraint)-14</td>
</tr>
<tr>
<td>Access to finance</td>
<td>1.9</td>
<td>3</td>
</tr>
<tr>
<td>Electricity</td>
<td>1.3</td>
<td>1</td>
</tr>
<tr>
<td>Tax rates</td>
<td>1.3</td>
<td>2</td>
</tr>
<tr>
<td>Informality</td>
<td>1.2</td>
<td>-</td>
</tr>
<tr>
<td>Quality of labor force</td>
<td>1.2</td>
<td>5</td>
</tr>
<tr>
<td>Tax administration</td>
<td>0.9</td>
<td>4</td>
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Note: The area of informality is introduced in the MICS (2012).
Top constraint is access to finance despite improvements in the legal and regulatory environment for getting credit.

Pre- and Post-Crisis Credit Growth in the Western Balkans

Quarter on quarter percentage change

- Albania
- BiH
- Kosovo
- Macedonia, FYR
- Montenegro
- Serbia

Supply of electricity is another major constraint.

Firm perceptions of tax rates may reflect the tax burden relative to the unfair competition from the informal sector.

Total Tax Cost Borne by the Average Firm in Montenegro, 2012

Percentage of profits

Legal Environment for Doing Business

Steady and significant improvements

Ease of Doing Business, 2011-13

Source: Doing Business.
Several areas still need attention...construction permits, enforcing contracts, and registering property

Mean Rankings in the Ten Areas Measured by Doing Business, 2012

Source: Doing Business.
Product Market Regulation

Flexibility is associated with accelerated productivity growth

Productivity Acceleration and Product Market Regulation

Percentage point change in the average MFP growth from 1985-95 to 1996-2007

Average ETRC indicator 1985-1995
Score: 0-6 (most restrictive)

Note: The ETCR indicator summarizes regulatory provisions in seven sectors: telecoms, electricity, gas, post, rail, air passenger transport, and road freight.
Source: OECD (2012).
Montenegro lags behind OECD or most small EU states

PMR indicator includes indicators of: (i) State control; (ii) Barriers to entrepreneurship; and (iii) Barriers to trade and investment.

Aggregate PMR Score

Score: 0-6 (most restrictive)
Areas for PMR improvement

- State control and barriers to trade and investment remain high
- High and widespread public ownership
- Information should be made more accessible to foreign parties
- Domestic regulations do not conform completely to the international standards
Labor Market Regulation

• Growth has been the primary driver of labor market performance...
• But, low labor force participation and employment, and persistent unemployment

Source: Eurostat and national statistical offices.
Less flexibility in hiring due to shorter maximum term of fixed contracts and high minimum wage

**Areas Contributing to Rigidity of Hiring Sub-Index**

- **Montenegro**
- **Frontier in the group**

Source: Doing Business.
Redundancy costs are not particularly high

Notice period for redundancy dismissal (salary weeks)

Severance pay for redundancy dismissal (salary weeks)

Source: Doing Business.
Policy Recommendations

Sustain the **fiscal consolidation** plans to reduce unsustainably high debt, clear the arrears and create fiscal reserves.

Ensure **financial sector sustainability** through strengthened supervision and **improve financial discipline**.

Continue **improving investment climate** to reach the global top 20.

Improve the **product market regulation** and downsize government portfolio in commercial sectors.

Ease the **labor market regulation** and reduce disincentives to work.
Thhhh hhh