Montenegro Gap Analysis
E&E/USAID
November 8, 2010 draft

Introduction and highlights. This analysis draws from the E&E's Monitoring Country Progress system, and examines progress and remaining transition and development challenges in Montenegro in economic and democratic reforms, macro-economic performance, human capital, and peace & security. Highlights include:

- Montenegro is roughly Southern Tier CEE average on *democratic reforms*, and closer to Eurasian average on *economic reforms*.
    - Of the five MCP dimensions, Montenegro is the most advanced in *human capital*.
    - Progress in *macroeconomic performance* is very uneven, with salient gaps in the labor market, macroeconomic stability, and the development and competitiveness of the export sector.
    - *Peace and security* is advanced by Southern Tier CEE standards, though not quite as peaceful and secure as Romania, Bulgaria, and Croatia.

- Montenegro is a late-comer to the economic and democratic reform processes. Such reforms did not begin in earnest until 1999-2000 and second stage economic reforms did not begin until 2002, though have moved forward steadily since then.
    - From 2002-2009, democratic reforms on balance were largely stagnant.
        - There has been notable erosion in the development of an independent media since 2005.
        - While there may have been modest gains in reducing corruption in the past several years, corruption remains significant by regional standards. According to Freedom House, of the CEE countries, only Kosovo has greater corruption than does Montenegro.

- We projected future economic and democratic reform progress in Montenegro by extrapolating the average annual rate of change in economic and democratic reforms from 2005-2009, and found that Montenegro is not likely to meet the proposed phase-out threshold (of the progress of such reforms on average in Bulgaria, Croatia, and Romania in 2006) until the year 2020.

- Montenegro's economy has been hit hard by the global economic crisis.
    - Its economy contracted by about 6% in 2009 and is likely to contract again in 2010. Only four other transition economies are currently forecast to contract in 2010: Kyrgyzstan; Romania; Croatia; and Latvia.
    - Montenegro's economy still has not resumed its pre-transition economic size.

- Labor market challenges are significant.
    - While the unemployment rate had been decreasing significantly prior to the global economic crisis, it still remains very high: 18% in 2008 and is likely higher now.
    - 26% of Montenegrin businesses surveyed in 2008 felt that the skills and education of the labor force was a significant obstacle to doing business. Out of a possible fourteen business constraints, only burdensome tax rates and the reliability of electricity were deemed more problematic.

- Regional disparities are significant.
    - Human development in Montenegro ranges from a level found in the North which is comparable to that overall in Azerbaijan and not much more advanced than in Thailand, to a level of development in Podgorica which is comparable to that found in Uruguay, and close to the level of development in Lithuania.
    - The North lags behind the rest of the country first and foremost in economic terms (or per capita GDP income), and secondarily in education. In contrast, there is very little disparity across the regions in terms of health (as measured by life expectancy). In fact, life expectancy is slightly higher in the North than elsewhere.
    - The development gap between the North and the rest does not appear to be growing.

Transition progress overview. Montenegro and Serbia share a very similar economic and democratic reform profile; roughly Southern Tier CEE average on democratic reforms, and closer to Eurasian average on economic reforms (*Figure 1*). According to E&E's Monitoring Country Progress (MCP) indices, Montenegro ranks 12th out of 29 transition countries in progress in democratic reforms; much farther down in economic reforms: 21 out 29.

Figure 2 (in a separate electronic file) highlights progress in Montenegro across four of E&E's five MCP indices, disaggregated by the index components. The greater is the shaded blue area, the greater is the progress. Montenegro lags the most in the economic dimension and is the most advanced in human capital (health, education, per capita income and vulnerable groups). Progress in Montenegro's macroeconomic performance is very uneven, with salient gaps in the labor market, macroeconomic stability, and the development and competitiveness of the export sector. Of the seven democratization components tracked, anti-corruption efforts continue to lag the most in Montenegro. In addition, local public governance is notably more advanced than national governance.

Economic reforms over time (*Figures 3-6*). Montenegro is a late-comer to the economic reform process (*Figure 3*). Economic reforms did not begin in Montenegro until 1999. Good progress has been made since then, though Montenegro's progress in such reforms remains well below Southern Tier CEE average. In 2009, latest data available, Montenegro made economic reform gains in two dimensions (in competition policy and in infrastructure reforms), while backsliding in one dimension (large-scale privatization: a re-acquisition by the state of a significant stake in the country's largest exporter).

Moreover, most of the gains have been in first stage economic reforms; second stage economic reforms did not begin until 2002, though have moved forward steadily since then (*Figure 4*). Economic reforms in Montenegro are today roughly on par with Albania, though Albania started the process much earlier and since 2000 has witnessed very slow progress (*Figure 5*). In contrast, Serbia's economic reform progress over time tracks very closely with Montenegro's progress (*Figure 6*).

Democracy and corruption (*Figures 7-13*). Similar to progress in economic reforms, Montenegro did not start democratic reforms until relatively recently, until 2000, surging forward in the initial years (*Figure 7*). However, unlike Montenegro's progress in economic reforms, democratic gains stagnated soon after the initial surge; in fact, from 2002-2009, there has been no overall net gains in democratization in Montenegro. In 2009, the latest data available, there were both advances (in rule of law) and backsliding (in independent media) in democratization in Montenegro.

Figure 8 highlights the stagnation in Montenegro in several key democratization dimensions since 2003: slight advance in public governance (national and local governance combined); virtually no progress in the fight against corruption since 2003; and notable erosion in the development of an independent media since 2005. 2009 was

marked by several disputes between the government and the media, including lawsuits and fines against the media likely resulting in additional media self-censorship.

We compare Transparency International's effort to measure the perceptions of corruption with Freedom House's effort to measure the actual magnitude of corruption (*Figures 9-13*). In all these charts, the higher is the score, the lower is the corruption or perception of corruption as a problem. Drawing on cross-country comparisons, Freedom House's perhaps more objective measure of corruption suggests there exists a more significant challenge in Montenegro than does Transparency International's measure of the perception of corruption. According to Freedom House, corruption in Montenegro is comparable to that found in Albania, and of the CEE countries, only in Kosovo is corruption more problematic (*Figure 9*). According to Transparency International's perception measure, Montenegro's corruption is comparable to that found in Romania and not as problematic as it is in a handful of Southern Tier CEE countries, roughly Southern Tier CEE average in fact (*Figure 10*). Compared to countries outside the region, the perception of corruption in Montenegro is roughly comparable to that found in Cuba and not much more problematic to perceptions of corruption in Italy (*Figure 11*).

Both measures of corruption suggest modest gains in the fight to mitigate corruption in Montenegro in the past several years (*Figures 12* and *13*). However, medium-term progress has also been uneven: the perception of corruption slightly worsened in 2009 according to Transparency International. Freedom House assessed some regression in anti-corruption efforts in 2006, the year of Montenegro's independence.

Finally, on corruption, the World Bank/EBRD Business Environment and Enterprise Survey finds that while corruption in 2008 in Montenegro is perceived to be an obstacle to doing business in 19% of businesses in the country surveyed, five other obstacles were ranked even more problematic: (1) tax rates (45% of businesses found them to be at least a moderate obstacle to doing business in 2008); (2) electricity (43%); (3) skills and education of workers (26%); (4) access to finance (24%); and (5) tax administration (20%).

Montenegro's progress vis-à-vis the proposed phase-out threshold. *Figure 14* combines the economic and democratic reform trends in Montenegro and compares such progress over time with the proposed phase-out threshold. The threshold is the economic and democratic reform progress of Bulgaria, Romania, and Croatia in 2006. The significance of this threshold is twofold. First, it represents past USG phase-out policy; namely, 2006 was when USG foreign assistance to Bulgaria, Romania, and Croatia was concluded. Second, the threshold is consistent with the EU's analysis and definition of when transition progress is sufficient for a country to meet both the political and economic criteria for EU membership.

Figure 14 shows four years of very impressive economic and democratic reform gains starting in 1999, and slower yet still significant progress from 2002 to 2009. (The analysis above shows that most of those gains from 2002-2009 stemmed from economic

reform progress, not democratization). We project future progress by extrapolating from the recent past; specifically, by calculating the average annual rate of change in economic and democratic reforms from 2005-2009, a five year period. From this calculation, Montenegro is not likely to meet the proposed phase-out threshold until the year 2020.

Macroeconomic performance *(Figures 15-22)*. According to the MCP index (and as shown in *Figure 15*), Montenegro ranks 13 out of 29 countries in macro-economic performance, though as suggested above (and in *Figure 2*), the aggregate index score for Montenegro masks very considerable diversity in component scores. In addition to significant regional economic disparities, Montenegro's economy has been handicapped by a relatively small and undiversified export sector, significant macro-economic imbalances, and very high unemployment rates.

The E&E region has been hit disproportionately hard by the global economic crisis. The region witnessed a larger economic contraction in 2009 than any other major region in the world, and continues to experience one of the slowest economic recoveries in 2010 of the regions of the world. In that context, Montenegro's economy has fared worse than the E&E standard (*Figure 16*); its economy contracted by about 6% in 2009 and is likely to contract again in 2010. Only four other transition economies are currently forecast to contract in 2010 according to the IMF (*World Economic Outlook*, October 2010): Kyrgyzstan; Romania; Croatia; and Latvia (*Figure 17*).

Since the transition began, Montenegro's economy has experienced annual economic growth in excess of 5% in only three years: 2006; 2007; and 2008 (*Figure 16*). Moreover, Montenegro's economy still has not resumed its pre-transition economic size; i.e., the 2010 GDP of the Montenegro economy may not be much more than 80% of 1989 GDP (*Figure 18*). In CEE, only the economies of Bosnia-Herzegovina and Serbia have current GDPs less than 1989 GDPs; in Eurasia, this situation holds only in Georgia, Moldova, Ukraine, and Tajikistan.

Figures 19 and *20* highlight key macro-economic imbalances and vulnerabilities of the Montenegrin economy. The large current account deficit going into the global economic crisis exposed Montenegro's economy; the negative effects of the crisis itself forced some reduction in the current account deficit, though the deficit still remains very high, and external debt is high and increasing. One key mitigating factor is the large flow of foreign direct investment to help finance the deficit (*Figure 21*).

Montenegro's economy has been hit hard by the global crisis in no small part because of its dependence on very few export products (40% of exports in 2009 were aluminum and aluminum products) and dependence on trading partners which have also experienced significant economic contraction or stagnation. Though not quite to the extent of energy prices, the price of aluminum has fluctuated greatly in recent years. According to the IMF, the price of metals decreased by 8% in 2008 and 29% in 2009, yet is on track to increase by 31% in 2010. The main destinations of Montenegro exports in 2009 were

Serbia, 28% of exports, Greece, 17%, and Italy, 12%. The EU is predicted to be the region with the slowest economic growth worldwide in 2010, less than 1% growth.

The social transition (unemployment, education, health, and regional disparities). As shown in *Figure 15*, and as measured by the MCP index, Montenegro's human capital (dimensions which include health, education, and vulnerable groups) is relatively advanced by E&E standards, comparable to the lower range of the Northern Tier CEE standards and more specifically similar to the levels of human capital in Latvia and Lithuania.

Nevertheless, labor market challenges are significant. Unemployment rates are very high throughout most of the Balkans and particularly in the countries which once constituted Communist Yugoslavia. The unemployment rate in Montenegro, while very high, had been coming down quite impressively prior to the global economic crisis, from as high as almost 40% in 2003 to perhaps 16% in 2007 (*Figure 22*). It increased slightly to 18% in 2008, and it seems quite feasible that it has continued to increase in 2009 and 2010 given the economy's continued dismal performance. The youth unemployment rate may be slightly more than two times the national average in Montenegro; *Figure 23* shows it to be almost 40% in 2007, latest year available.

Perhaps related to the high unemployment rates in Montenegro and elsewhere in the Balkans, is the quality and relevance of the education systems in the region. *Figure 24* addresses this in part by highlighting the available "functional literacy" test results across various countries. Montenegro has to date participated in one such test (the PISA). The results suggest that school children in Montenegro are performing considerably below OECD standards, and closer to student performance in Azerbaijan and Albania.

The 2008 results from the World Bank and EBRD's Business Environment and Enterprise Performance Survey (or BEEPS) shed some additional light. Of those businesses surveyed in Montenegro, 26% felt that the skills and education of the labor force posed as an obstacle to doing business. This perceived obstacle ranked third out of 14 possible obstacles among Montenegro businesses in 2008; tax rates and electricity were perceived to be more problematic by more business (45% and 43% of businesses, respectively).

Life expectancy is 74 years in Montenegro (*Figures 25-28*). This is slightly below average for the CEE region (*Figure 27*), comparable to Serbia, slightly lower than in Albania and Bosnia (*Figure 28*). Females in Montenegro live almost five years longer than do males; i.e. female life expectancy is closer to 77 years, males 72 years. We show two time trends on life expectancy from two different sources since the results do not precisely align (*Figures 25* and *26*). According to MONSTAT, life expectancy has been increasing for both males and females in recent years, since 2005, in Montenegro. However, drawing from both the UNDP and MONSTAT estimates, life expectancy may still be lower in Montenegro in 2009 than in 1991, and with a larger decrease for females.

Montenegro's life expectancy trends over time are a contrast to the much more favorable upward trends in the CEE region (*Figure 27*).

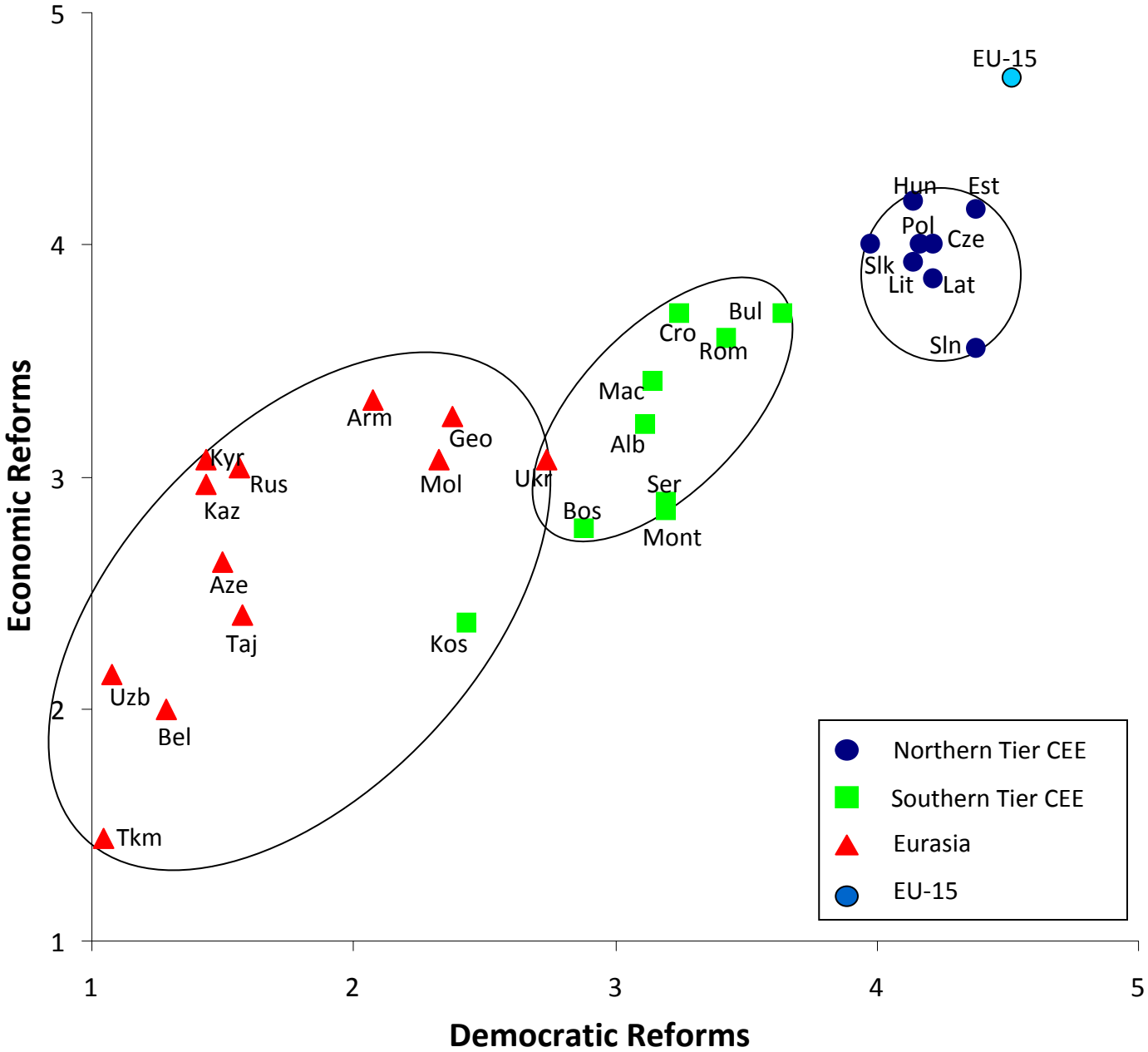
Regional disparities in Montenegro are significant (*Figures 29-33*). According to the UNDP's *Human Development Report of Montenegro* (2009), human development in Montenegro ranges from a level found in the North which is comparable to that overall in Azerbaijan and not much more advanced than in Thailand, to a level of development in Podgorica which is comparable to that found in Uruguay, and close to the level of development in Lithuania (*Figure 29*).

The UNDP's Human Development Index includes three aspects of development: health (measured by life expectancy); education (adult literacy rate and combined primary, secondary, and tertiary school enrollments); and per capita (GDP) income. *Figure 31* shows how the four regions of Montenegro compare on those three components. The North of Montenegro lags behind the rest of the country first and foremost in economic terms (or per capita GDP income), and secondarily in education. In contrast, there is very little disparity across the four regions in terms of health (as measured by life expectancy. In fact, life expectancy is slightly higher in the North than elsewhere.

Consistent with the findings that the North lags the most in the economic or per capita income aspect of human development, are the measures of poverty rates disaggregated by region within Montenegro (*Figure 32*). The differences in poverty rate, in other words, are very large. The poverty rate in the North is almost two times greater than that found in Podgorica and it is higher still relative to the South and the Center; almost three times higher in North compared to the South. The fact that roughly one-third of the population lives in the North (*Figure 33*) adds additional weight to the overall significance of these disparities. What is more encouraging, however, is that the development gap between the North and the rest does not appear to be growing, at least as measured by the Human Development Index; human development has been occurring across the four regions in recent years (*Figure 30*).

Peace & Security. Finally, we note Montenegro's cross-country position in the MCP Peace & Security index (*Figure 34*). By this measure, peace and security in Montenegro is advanced by Southern Tier CEE standards, though Montenegro is not quite as peaceful and secure as the three recent Southern Tier CEE graduates from the AEECA USG foreign assistance account, namely, Romania, Bulgaria, and Croatia. Six components make up the index and these aspects of peace and security correspond to the six components of the U. S. government's foreign assistance strategic framework of peace and security: counter-terrorism; counter-narcotics; combating weapons of mass destruction; combating transnational crime; stabilization operations and security sector reform; and conflict mitigation. Montenegro's scores across the six dimensions are relatively similar, its profile relatively balanced. In that context, Montenegro lags the most in combating weapons of mass destruction and combating transnational crime.

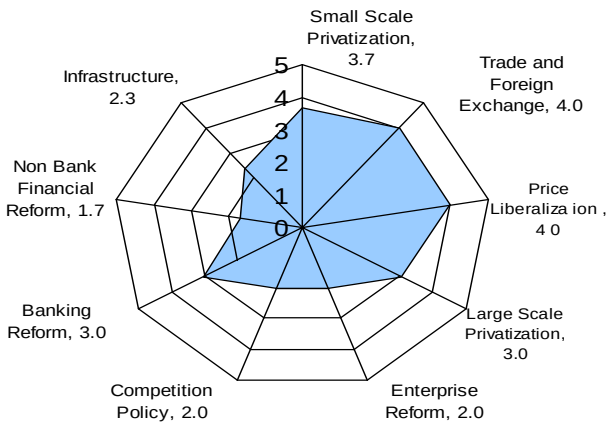
Fig. 1: Economic and Democratic Reforms in 2009



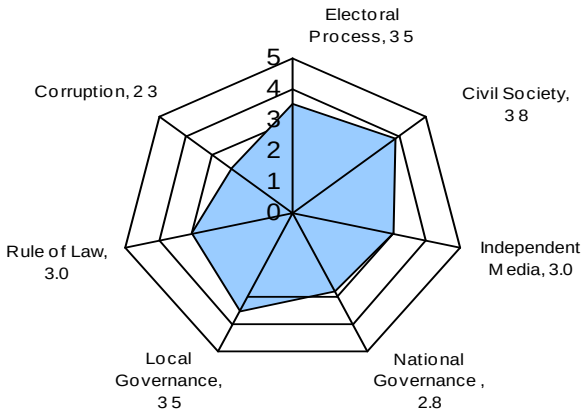
Ratings are based on a 1 to 5 scale, with 5 representing most advanced. Freedom House, *Nations in Transit 2010* (June 2010); and EBRD, *Transition Report 2009* (November 2009).

Fig. 2: Montenegro

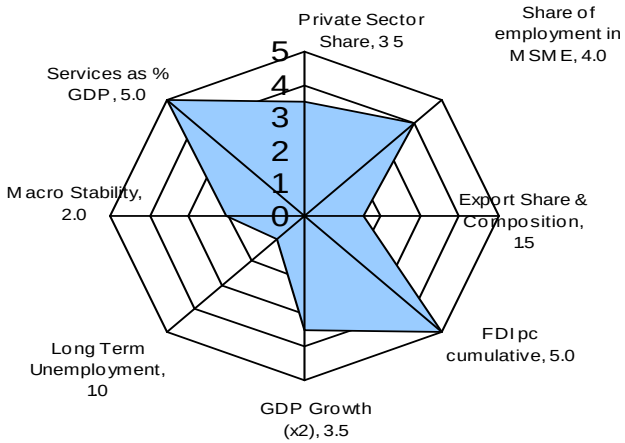
Economic Reform in 2009



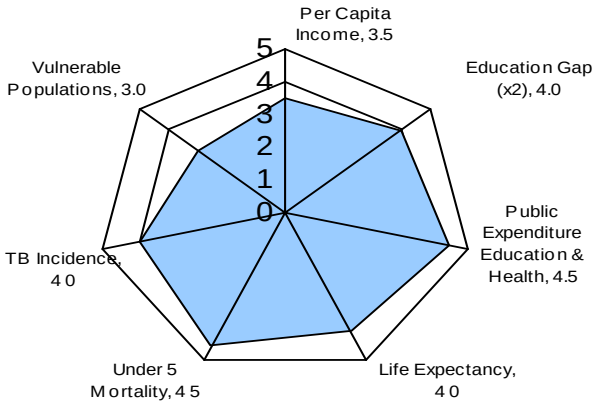
Democratic Reform in 2009



Economic Performance in 2007-2009

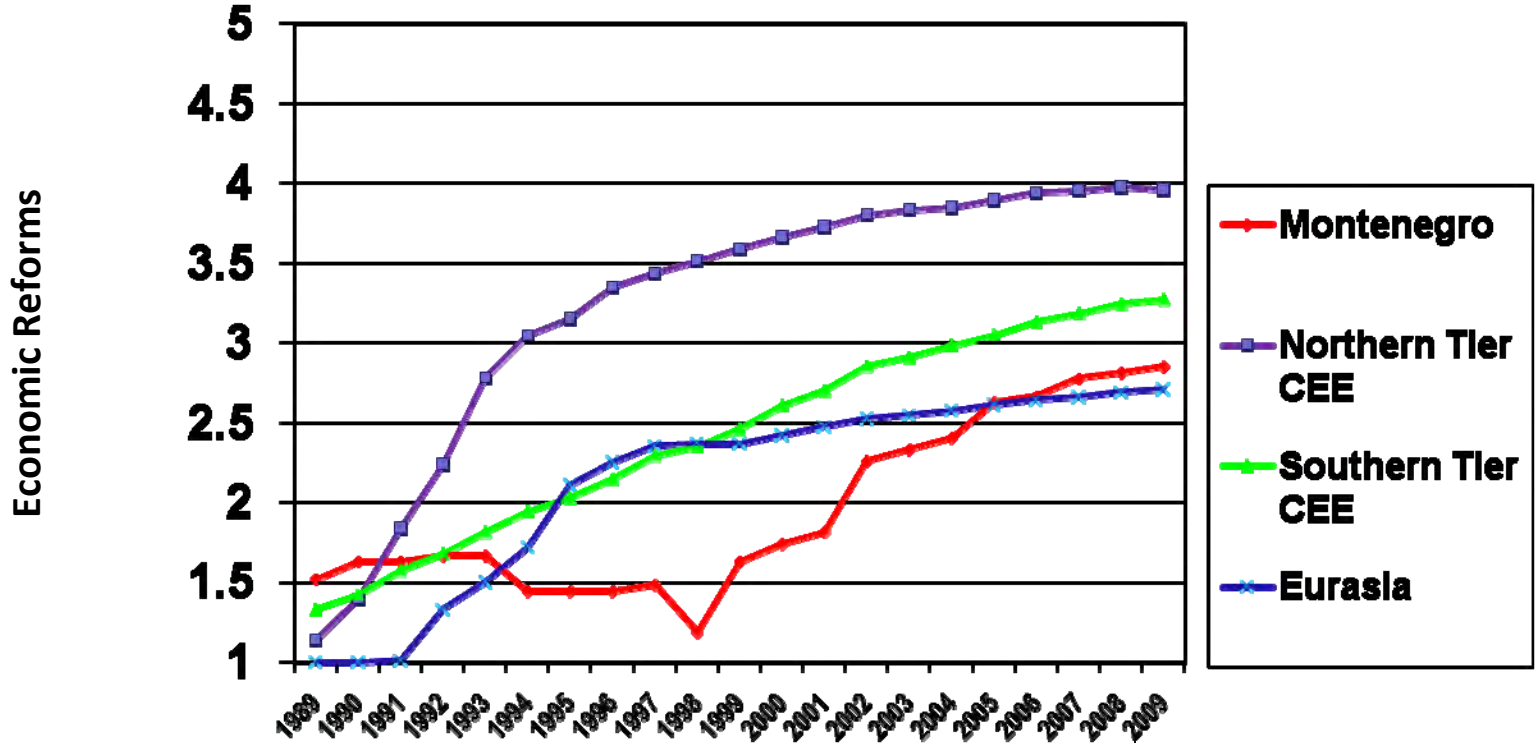


Human Capital in 2007-2009



Ratings are based on a 1 to 5 scale, with 5 representing most advanced. USAID, *Monitoring Country Progress #12* (April 2010 forthcoming).

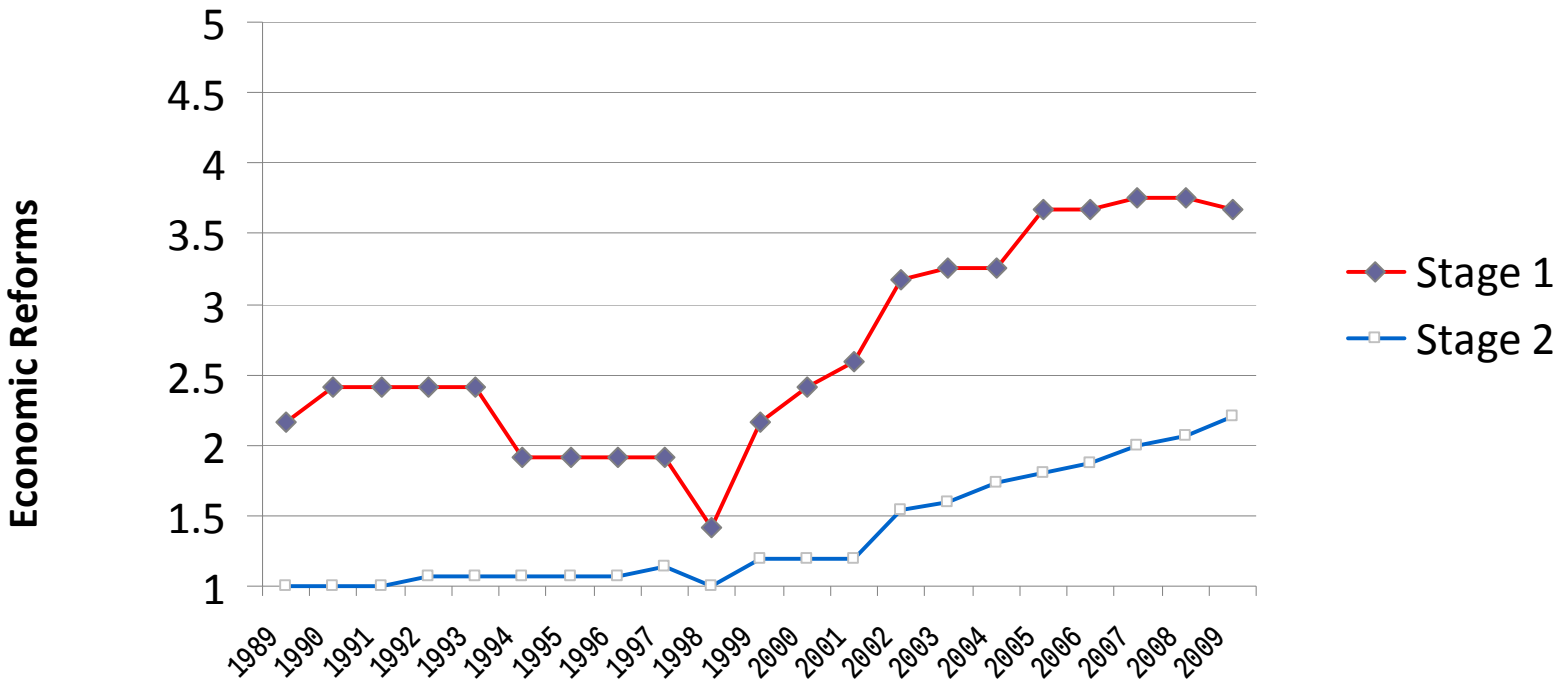
Fig. 3: Economic Reform in Montenegro vs. Transition Regions



Northern Tier CEE: Hungary, Poland, Czech Republic, Slovakia, Slovenia, Latvia, Lithuania, Estonia. Southern Tier CEE: Romania, Bulgaria, Macedonia, Croatia, Serbia, Albania, Montenegro, Kosovo, Bosnia-Herzegovina. Eurasia consists of the former Soviet Union minus the 3 Baltic States: Russia, Ukraine, Moldova, Belarus, Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Kazakhstan, Tajikistan, Uzbekistan, Turkmenistan.

Ratings are based on a 1 to 5 scale, with 5 representing most advanced. Data are drawn from the EBRD, *Transition Report 2009* (November 2009).

Fig. 4: Economic Reform in Montenegro – Stage 1 vs. Stage 2 Reforms

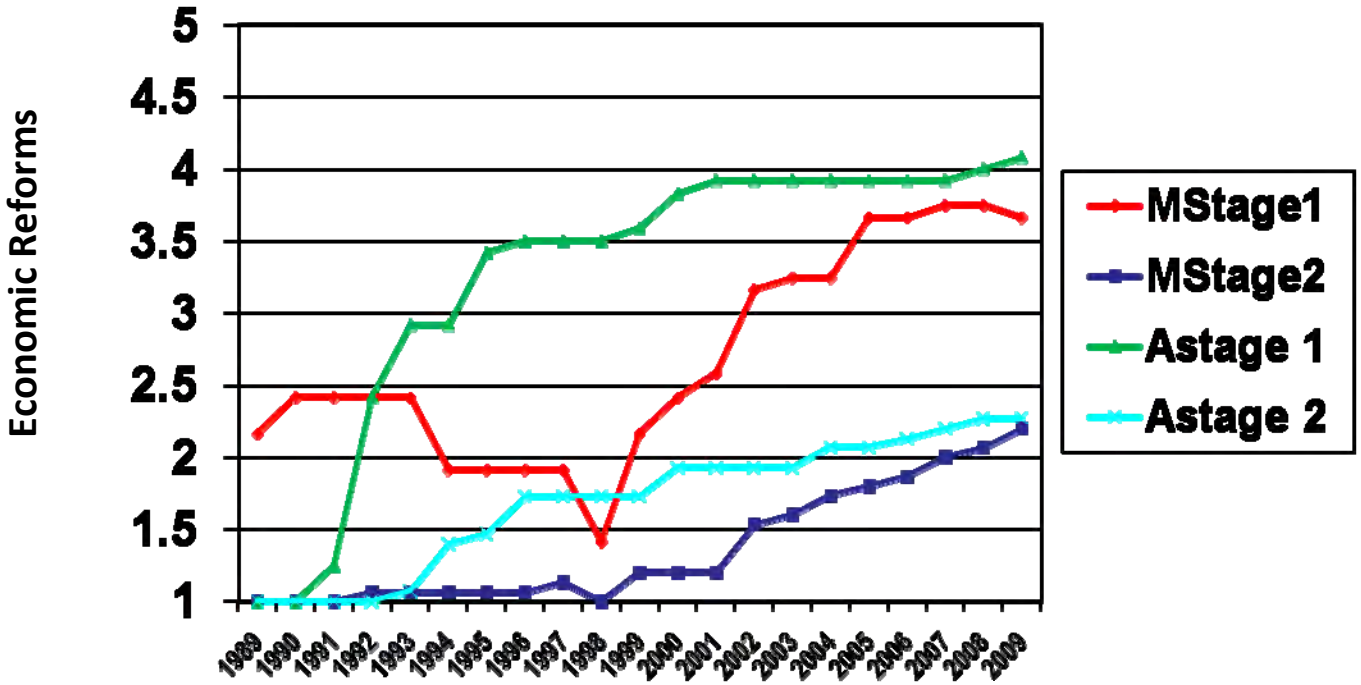


Stage 1 encompasses the following indicators: 1) Small Scale Privatization, 2) Trade and Foreign Exchange, 3) Price Liberalization, and 4) Large Scale Privatization.

Stage 2 encompasses the remaining indicators: 1) Enterprise Reform, 2) Competition Policy, 3) Banking Reform, 4) Non-Bank Financial Reform, and 5) Infrastructure.

Ratings are based on a 1 to 5 scale, with 5 representing most advanced. Data are drawn from the EBRD, *Transition Report 2009* (November 2009).

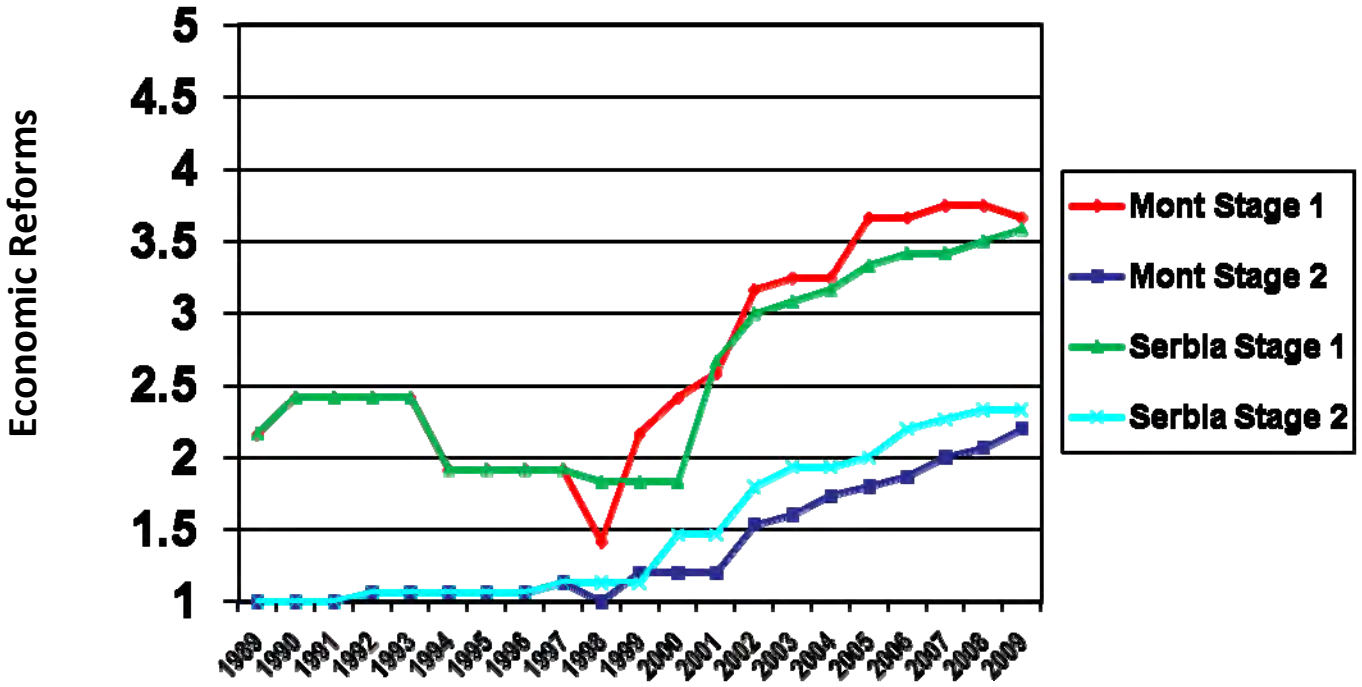
Fig. 5: Economic Reform in Montenegro – Stage 1 vs. Stage 2 Reforms Compared to Albania



Stage 1: Small Scale Privatization, Trade and Foreign Exchange, Price Liberalization, Large Scale Privatization. Stage 2: Enterprise Reform, Competition Policy, Banking Reform, Non-Bank Financial Reform, Infrastructure.

Ratings are based on a 1 to 5 scale, with 5 representing most advanced. Data are drawn from the EBRD, *Transition Report 2009* (November 2009).

Fig. 6: Economic Reform in Montenegro – Stage 1 vs. Stage 2 Reforms Compared to Serbia

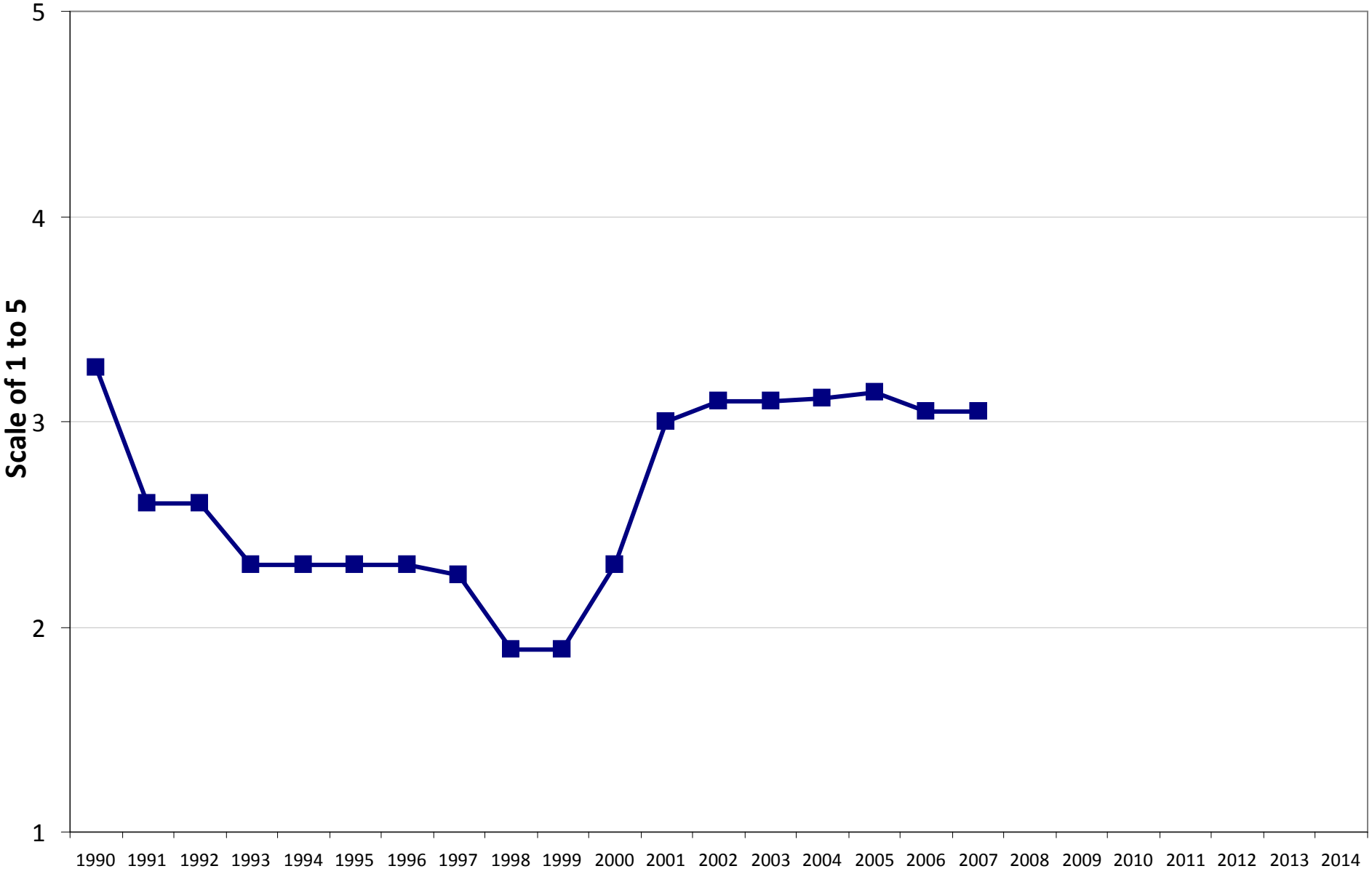


Stage 1: Small Scale Privatization, Trade and Foreign Exchange, Price Liberalization, Large Scale Privatization. Stage 2: Enterprise Reform, Competition Policy, Banking Reform, Non-Bank Financial Reform, Infrastructure.

Ratings are based on a 1 to 5 scale, with 5 representing most advanced. Data are drawn from the EBRD, *Transition Report 2009* (November 2009).

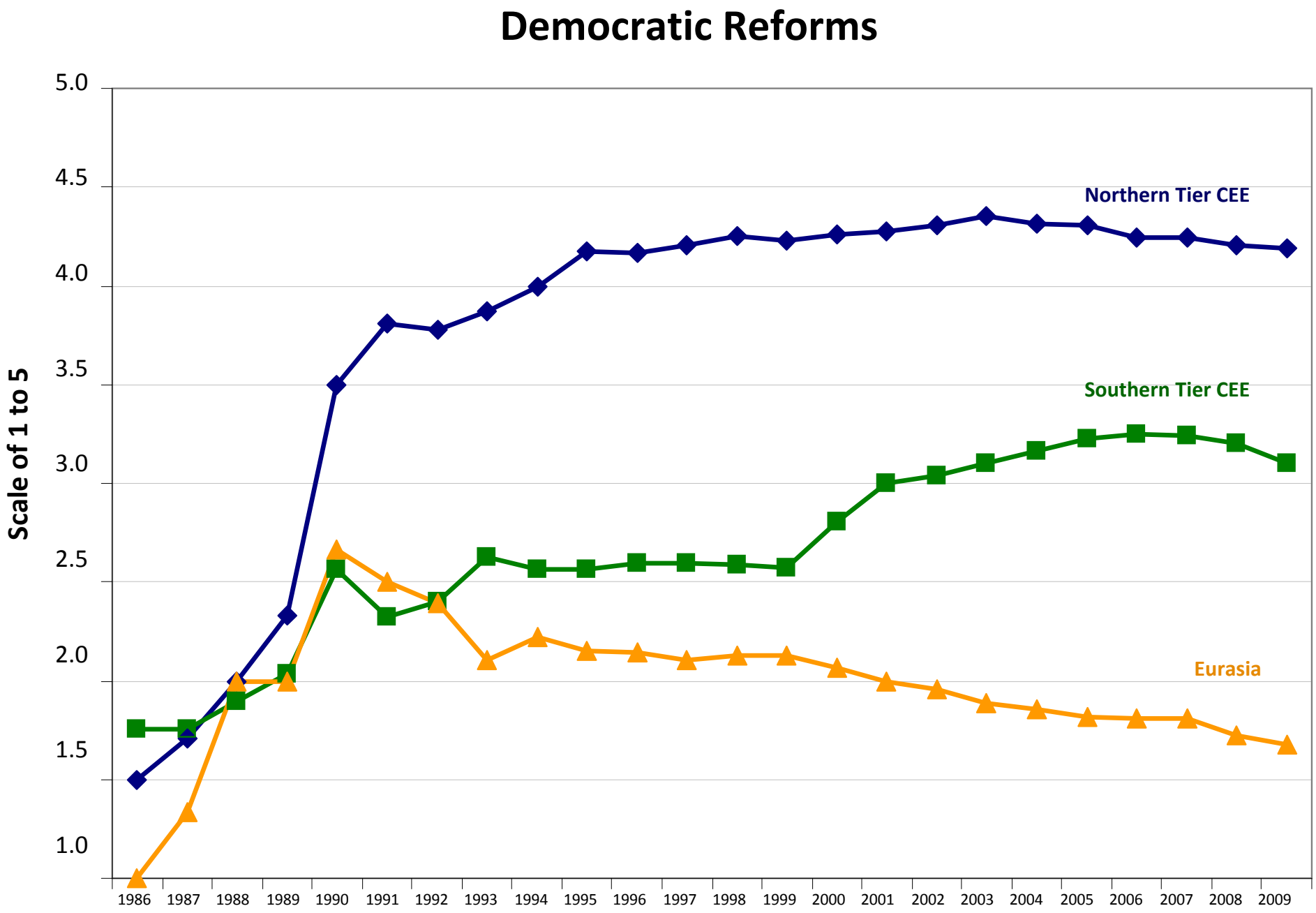
Figure 7

Democratic Reform in Montenegro



Ratings are based on a 1 to 5 scale, with 5 representing most advanced. Freedom House, *Nations in Transit 2007* (2007) and *Freedom in the World 2008* (2008);

Figure 7 cont'd



Ratings are based on a scale from 1 to 5, with 5 representing the best score. USAID drawing from Freedom House, *Nations in Transit 2009* and *Freedom in the World 2010* (January 2010).

Fig. 8: Democratic Reform Components in Montenegro over time

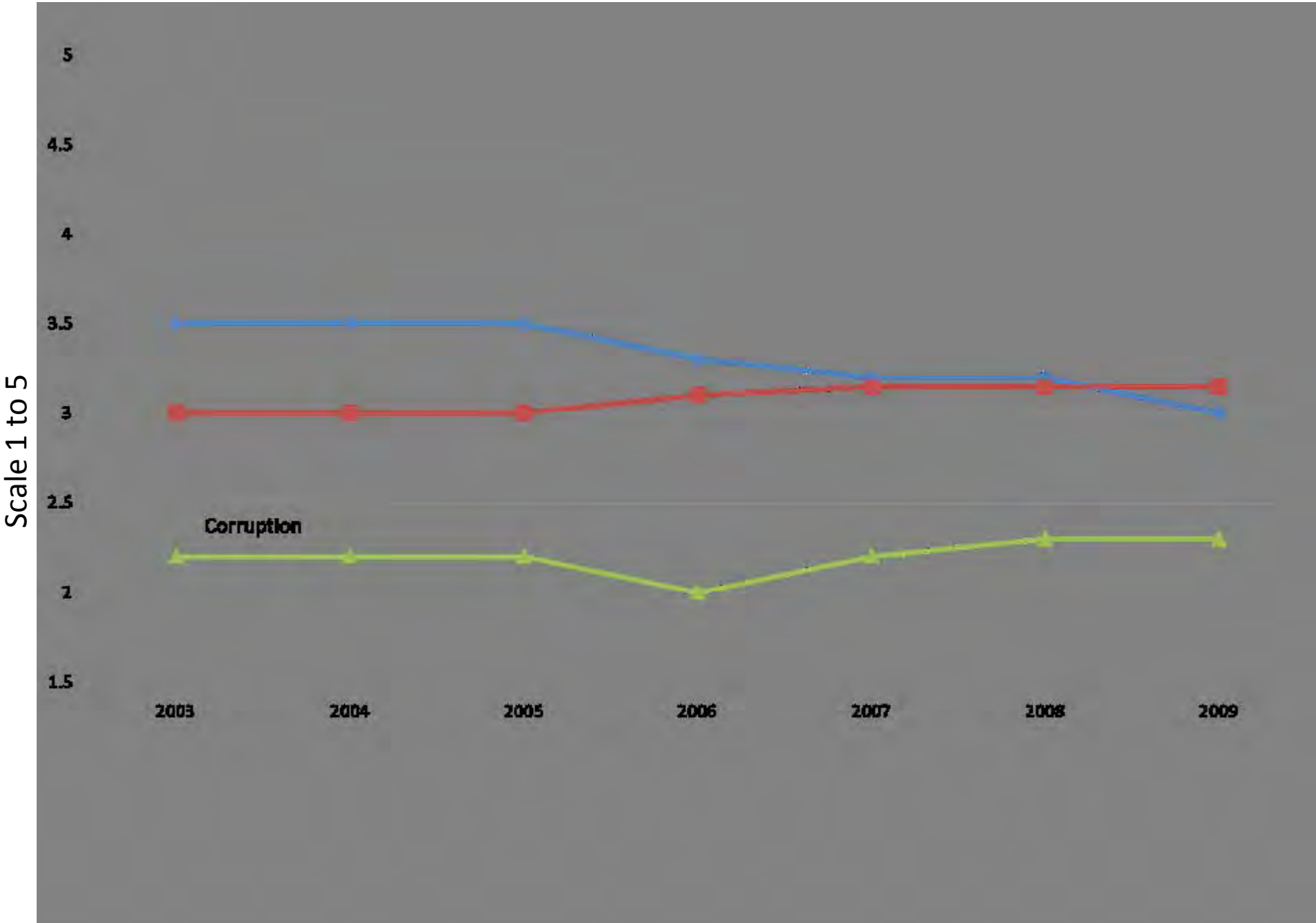
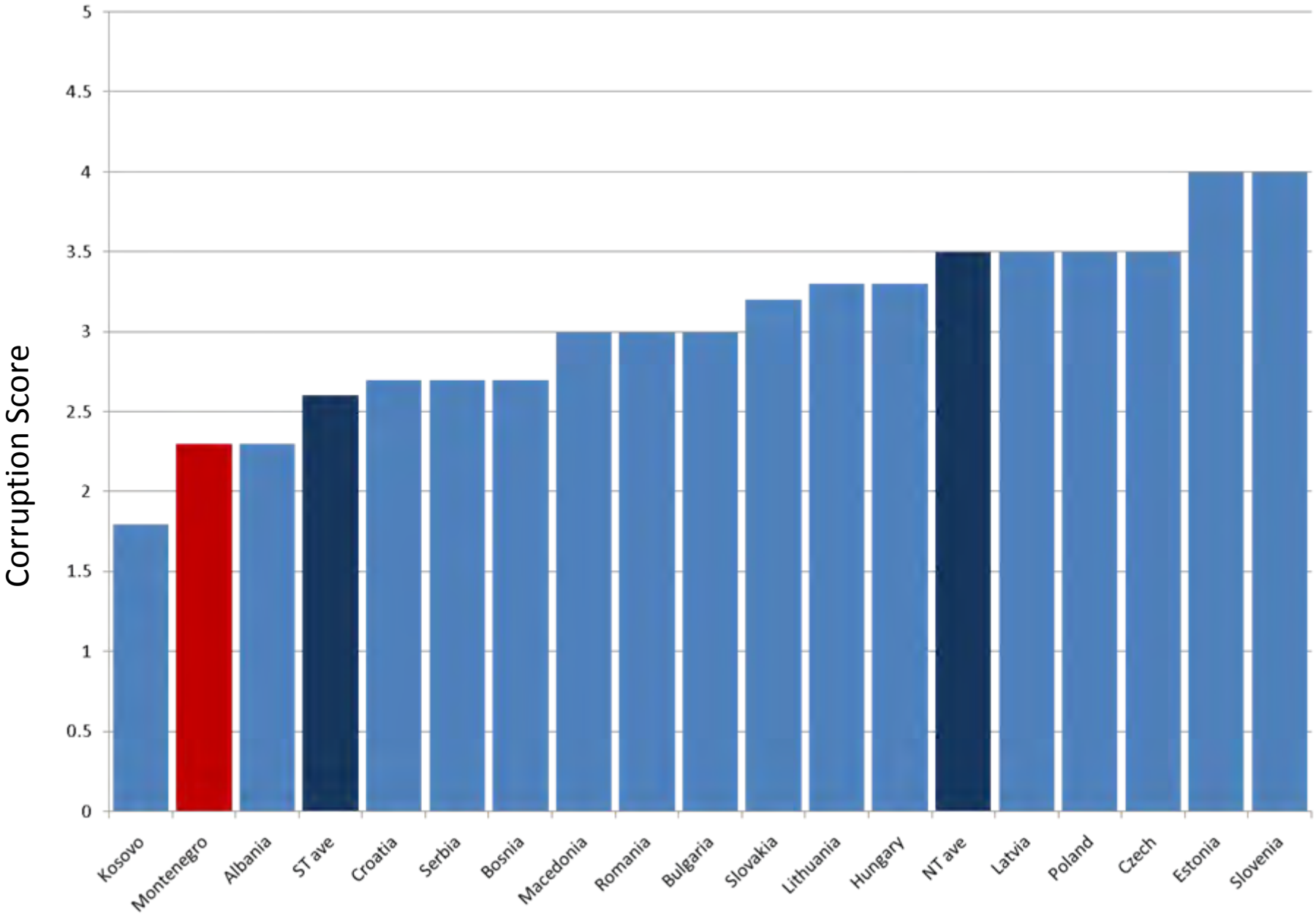
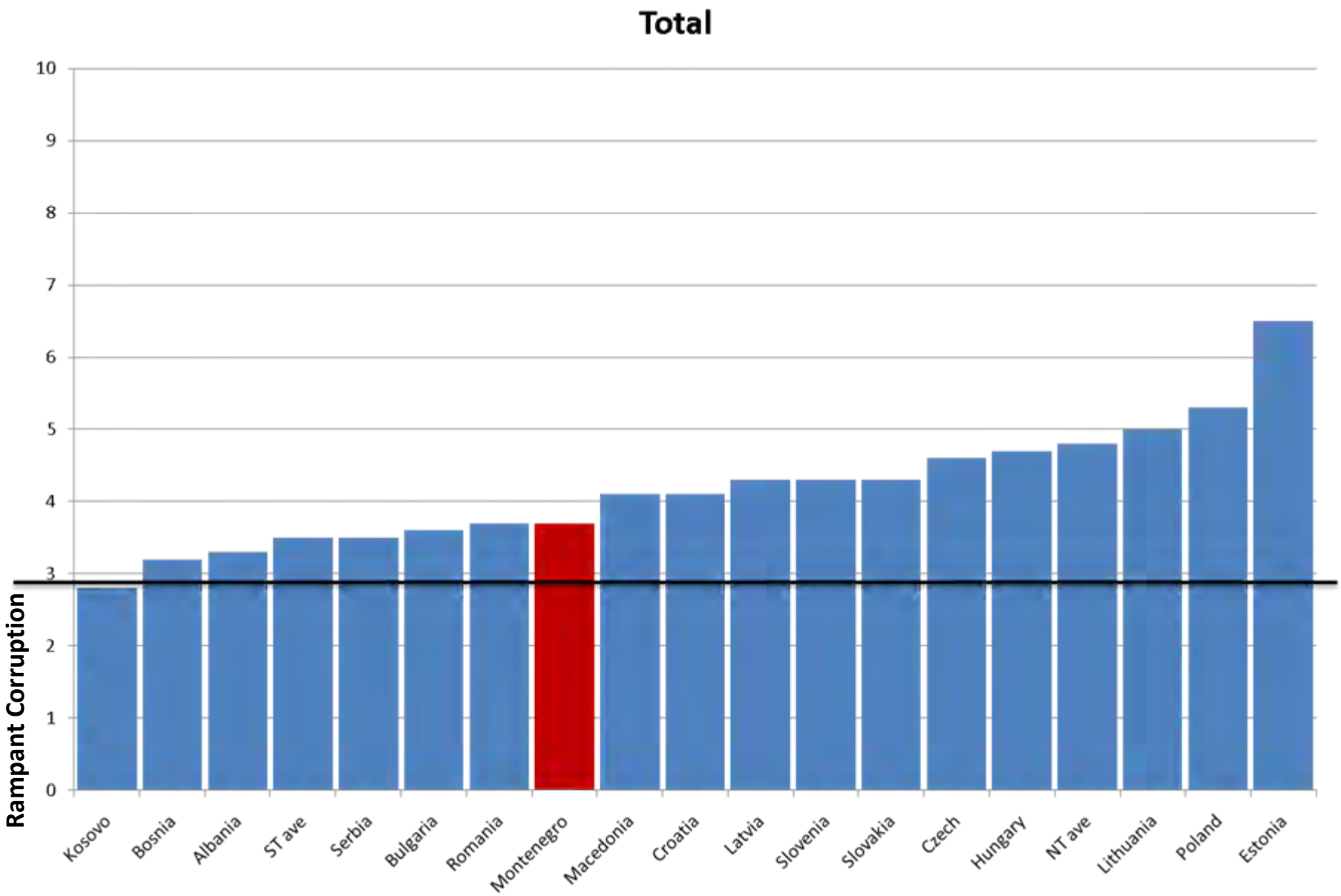


Fig. 9: Corruption Comparison of Northern and Southern Tier Countries



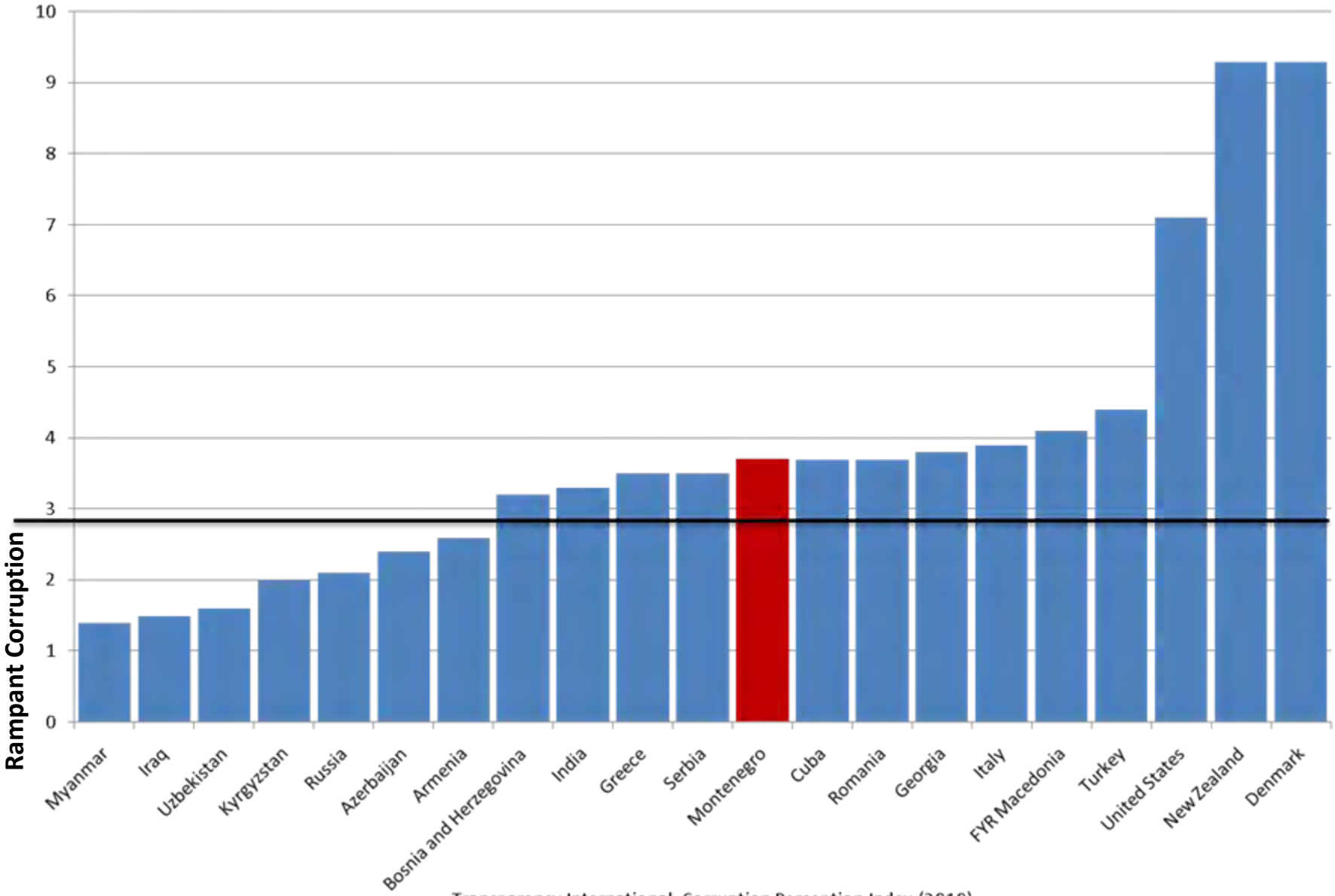
EBRD Transition Report; Freedom House Nations in Transit 2010.

Fig. 10: Corruption Perceptions in Eastern Europe



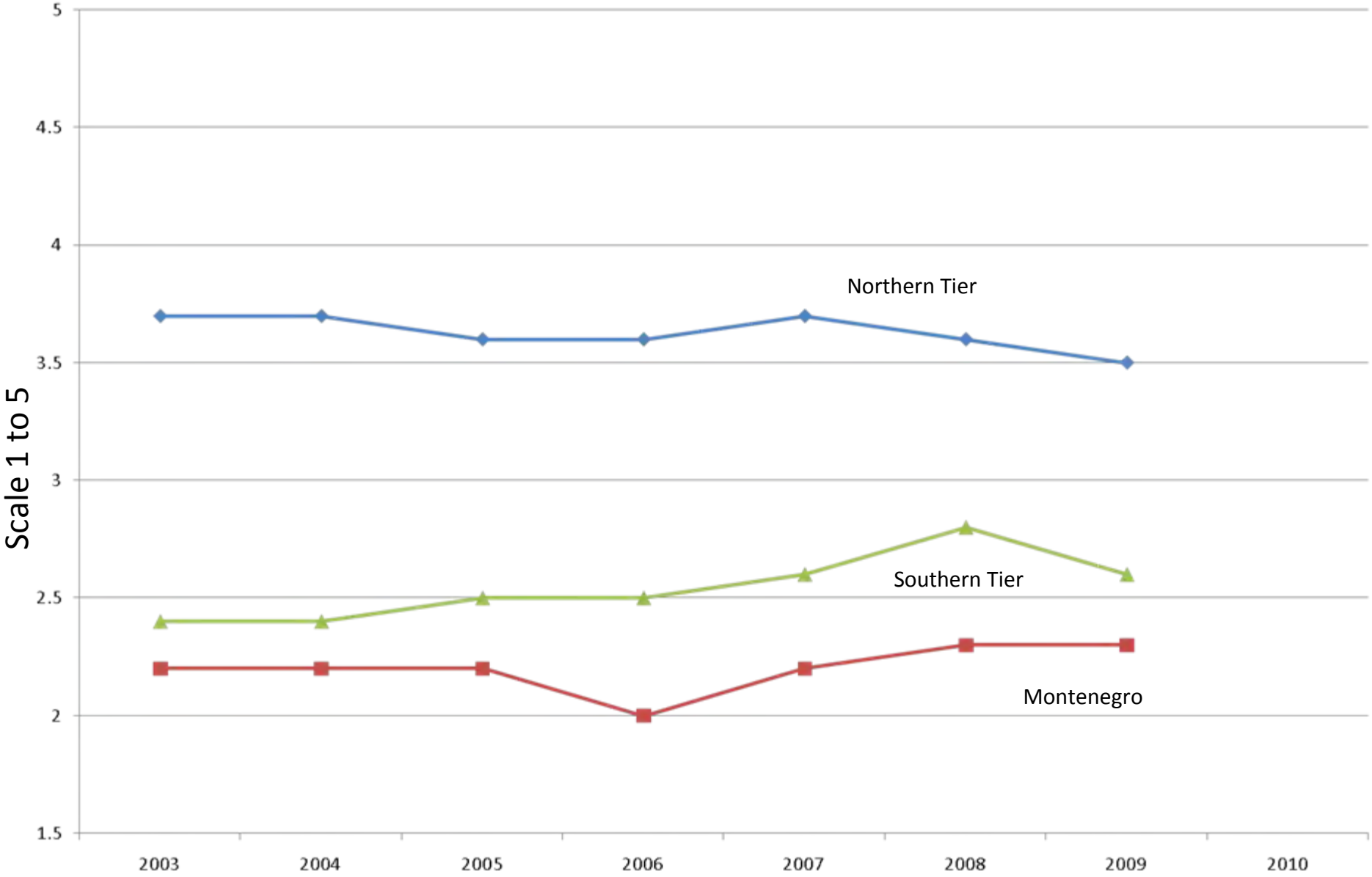
Transparency International, Corruption Perception Index (2010).

Fig. 11: Corruption Perceptions in the World



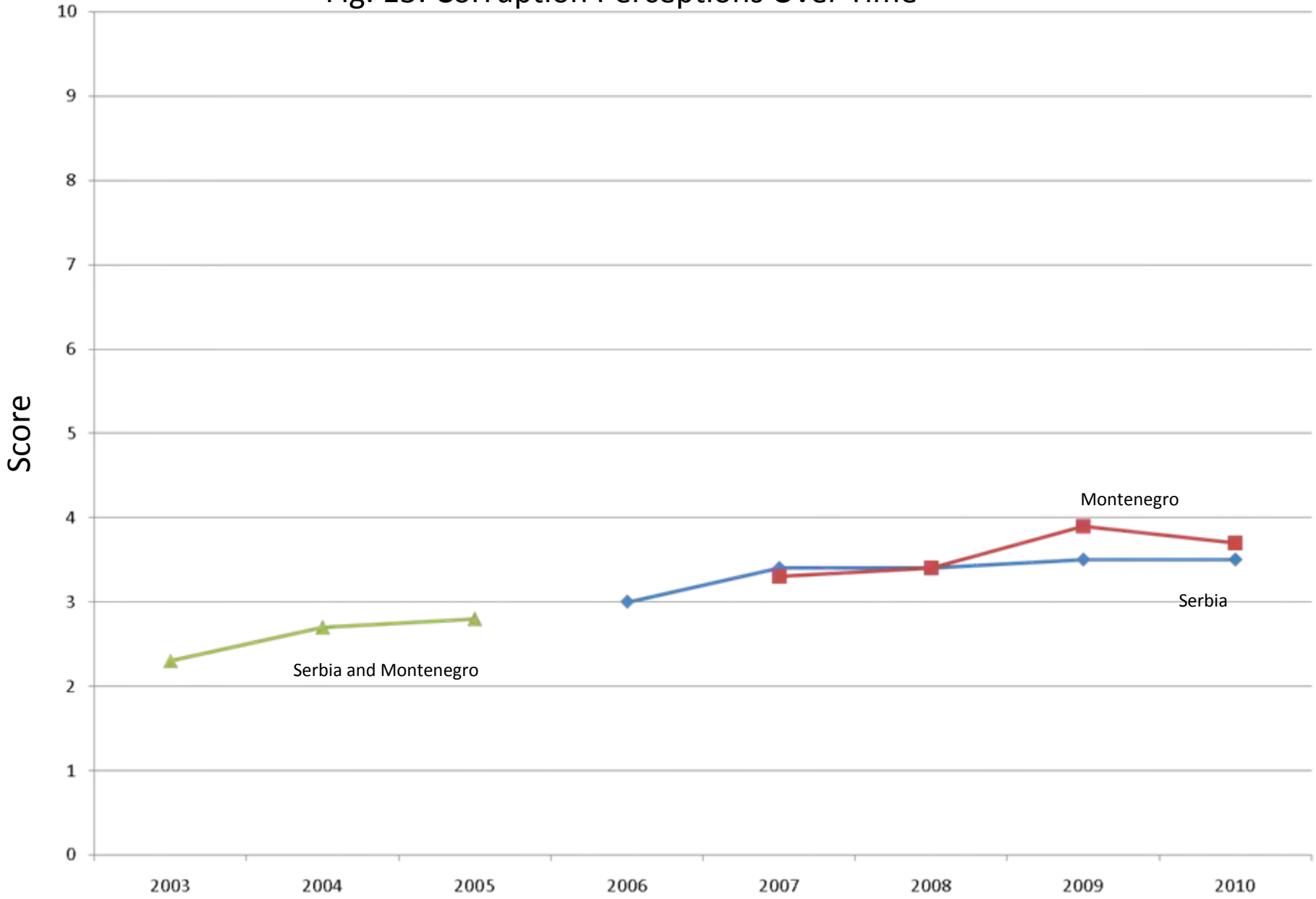
Transparency International, Corruption Perception Index (2010).

Fig. 12: Corruption Over Time



EBRD Transition Report; Freedom House Nations in Transit (various years). Extrapolation based on annual averagerate of change 2004-2010.

Fig. 13: Corruption Perceptions Over Time



Transparency International, Corruption Perception Index (various years). 2003-2010.

Montenegro

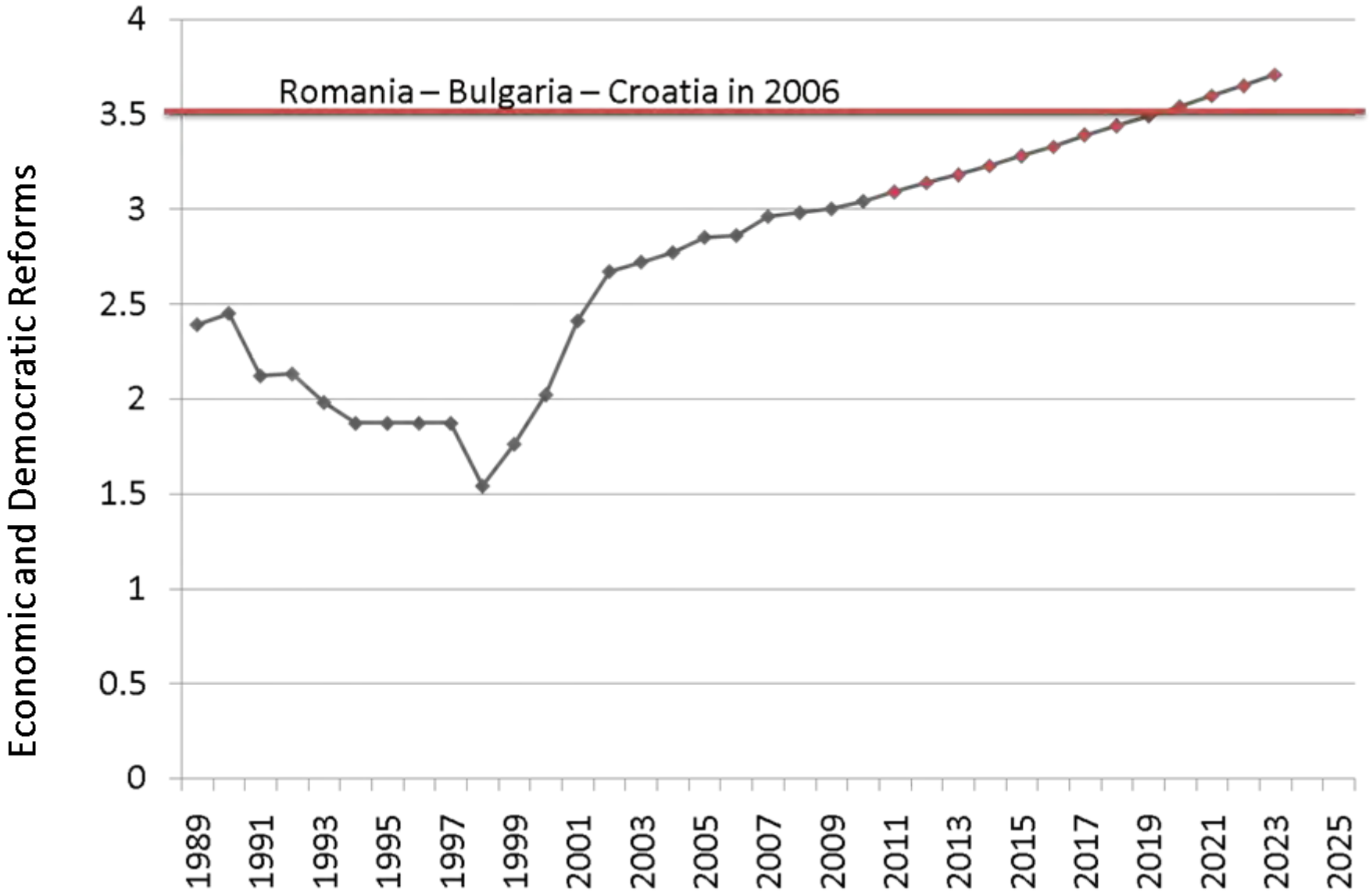

Romania – Bulgaria – Croatia in 2006
Economic and Democratic Reforms
4
3.5
3
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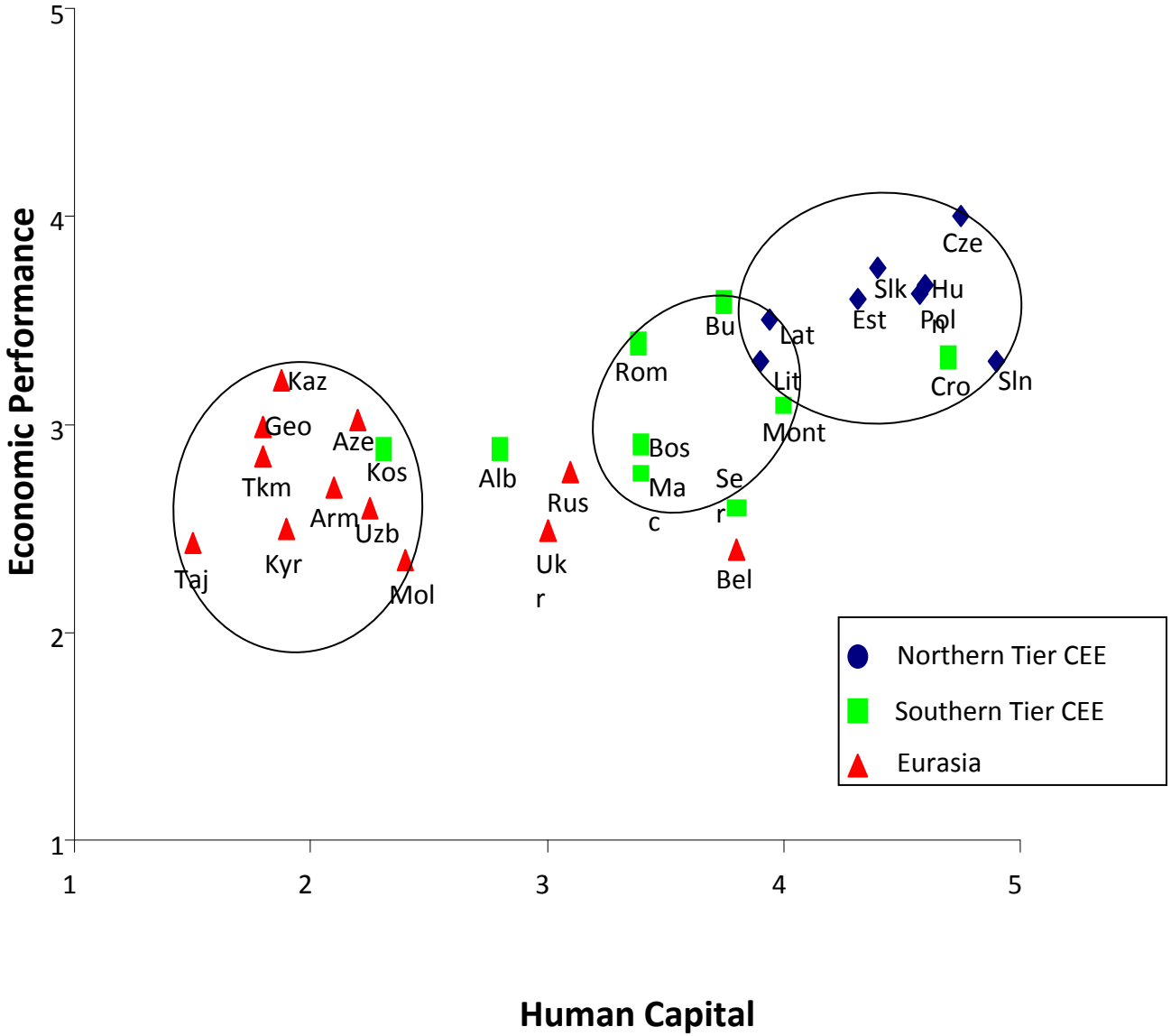
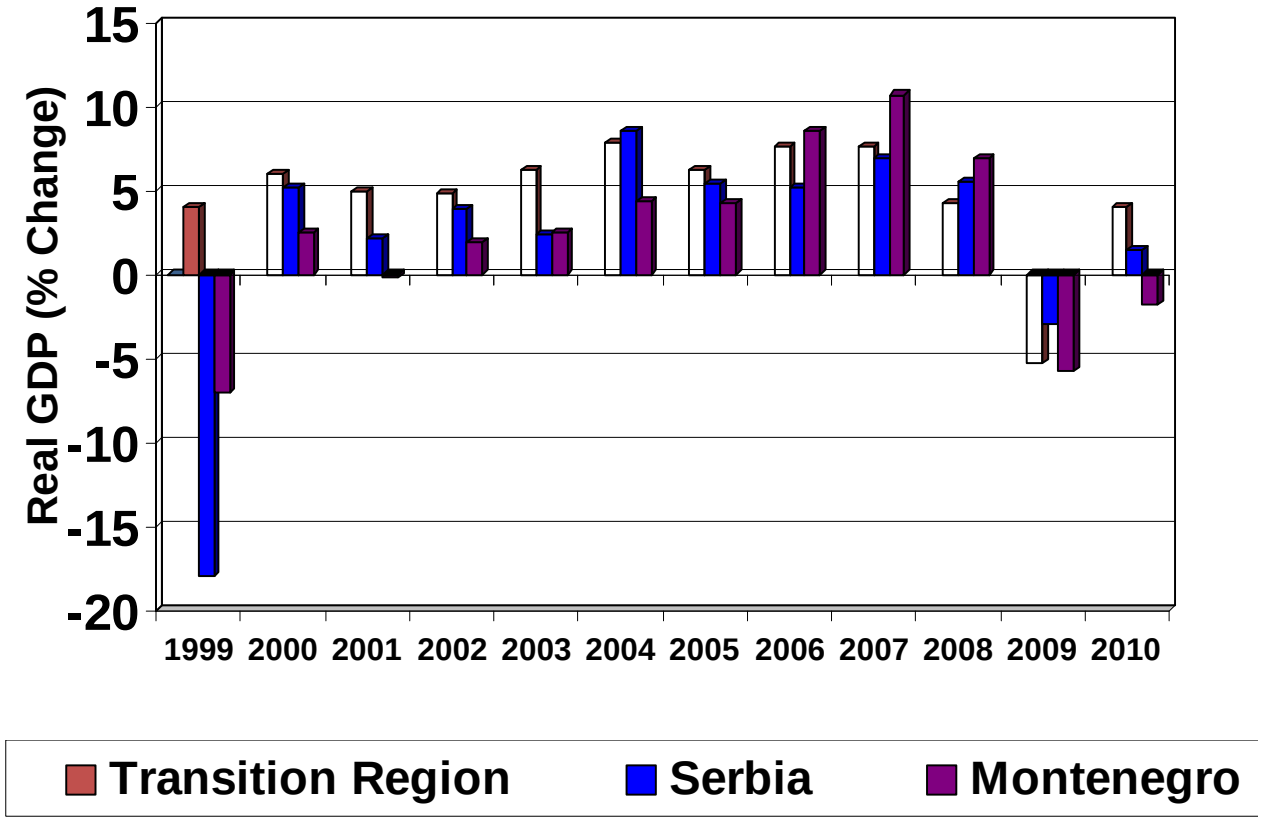
Figure 15

Economic Performance and Human Capital in 2007-2009



Ratings are based on a scale from 1 to 5, with 5 representing the best score. The arrows signify notable relative changes in 2008-2009. USAID/E&E, *Monitoring Country Progress in CEE & Eurasia* #12 (May 2010 draft), drawing from numerous organizations including the World Bank, EBRD, UNICEF, IMF, WHO, and OECD.

Fig. 16: Economic Growth Trends Compared



IMF, *World Economic Outlook* (October 2010).

Fig. 17: economic growth and contraction: the poorer performers in 2010

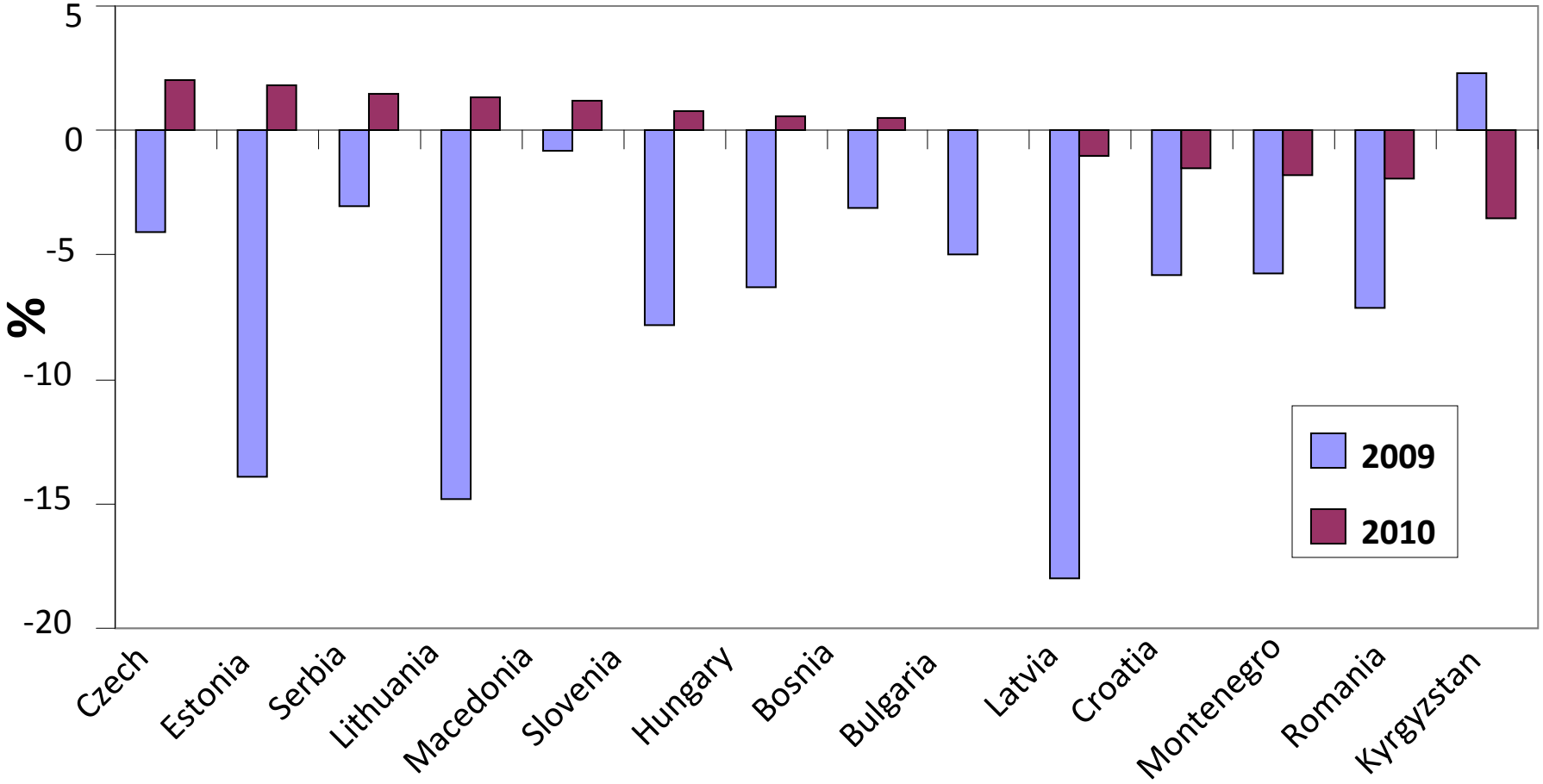


Fig. 18: Real GDP as % of GDP Level in 1989

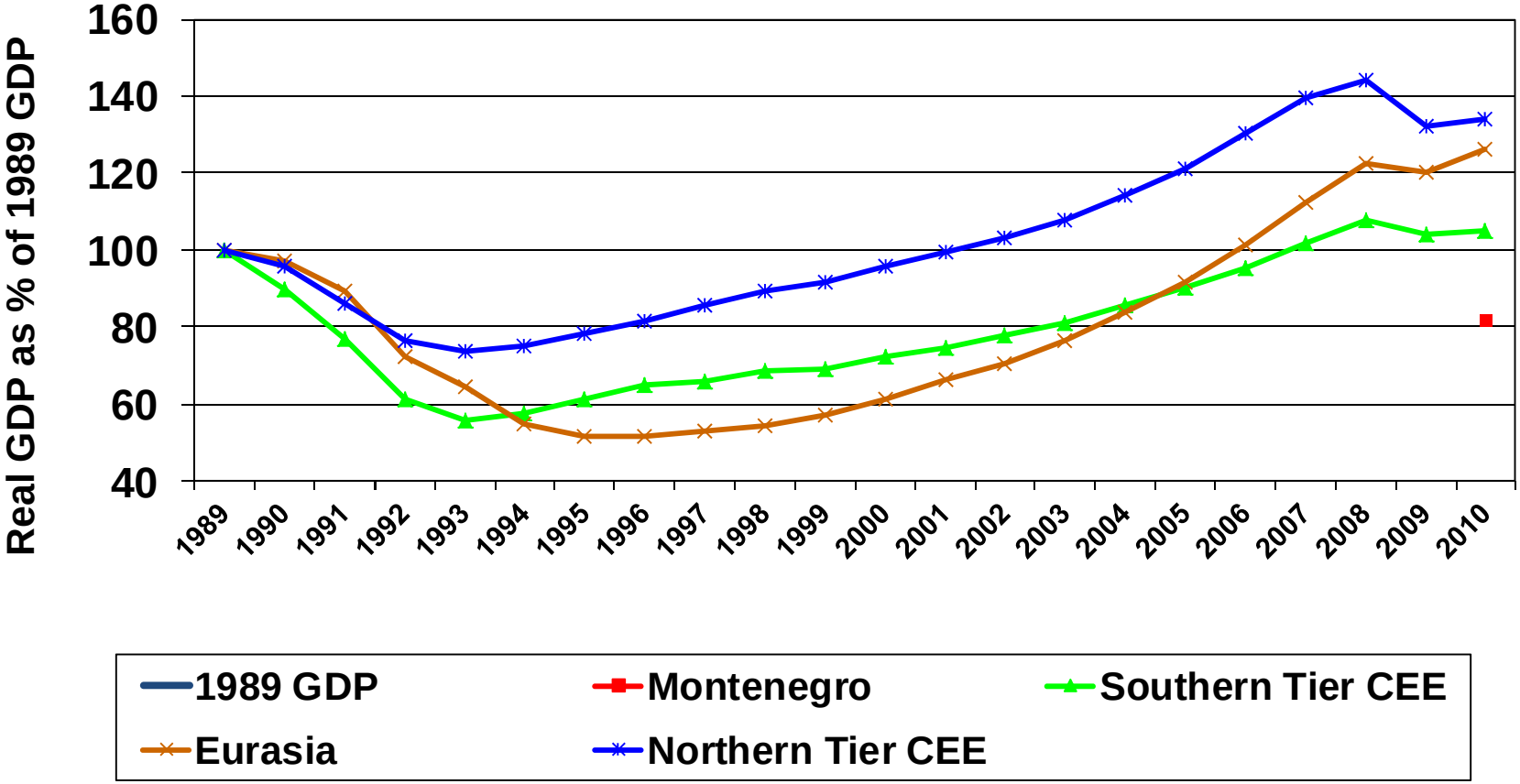
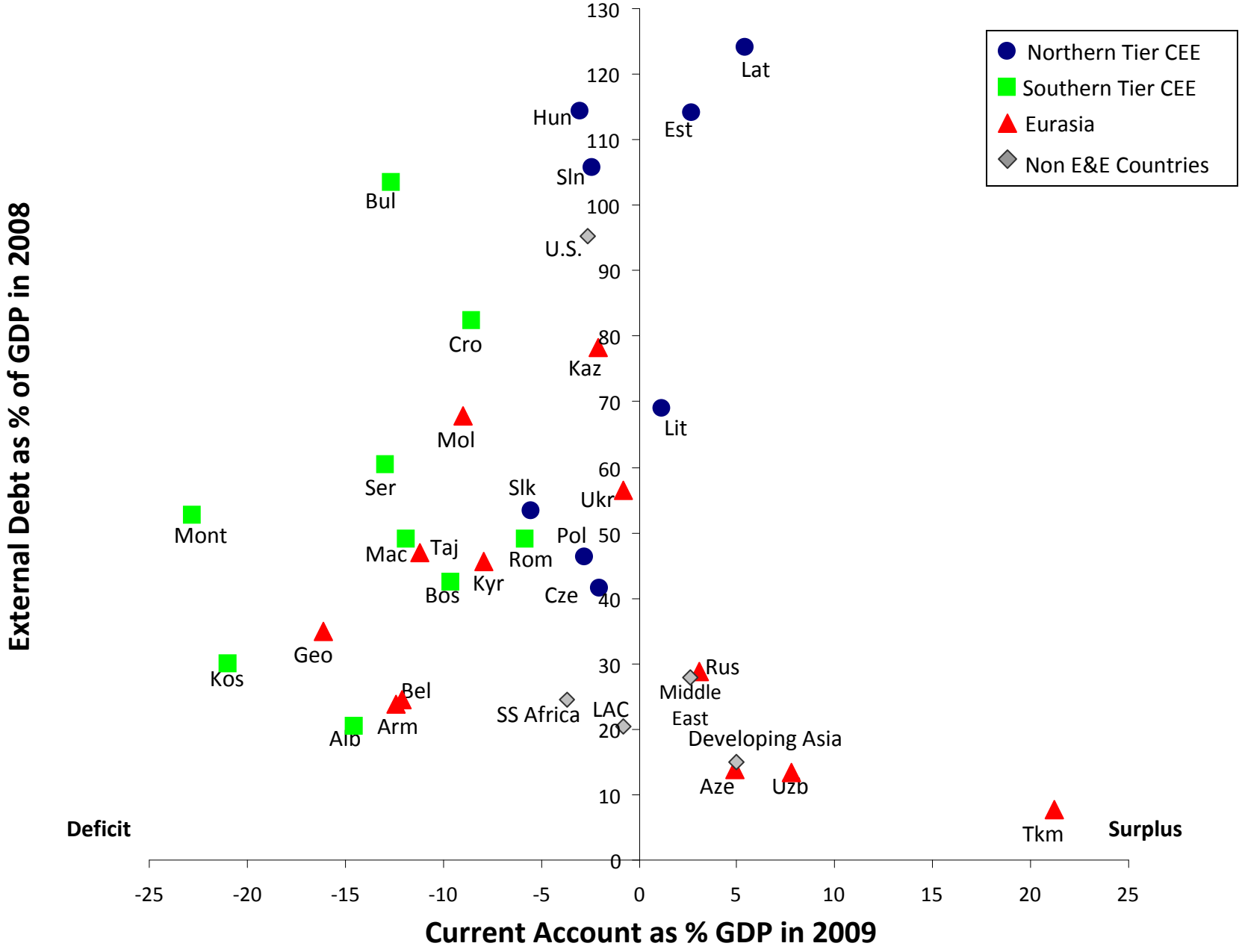


Figure 19

Current Account Balance & External Debt



EBRD, *Transition Report 2009* (November 2009) and IMF, *World Economic Outlook* (October 2008).

Fig. 20: Current Account Balance & External Debt as % of GDP

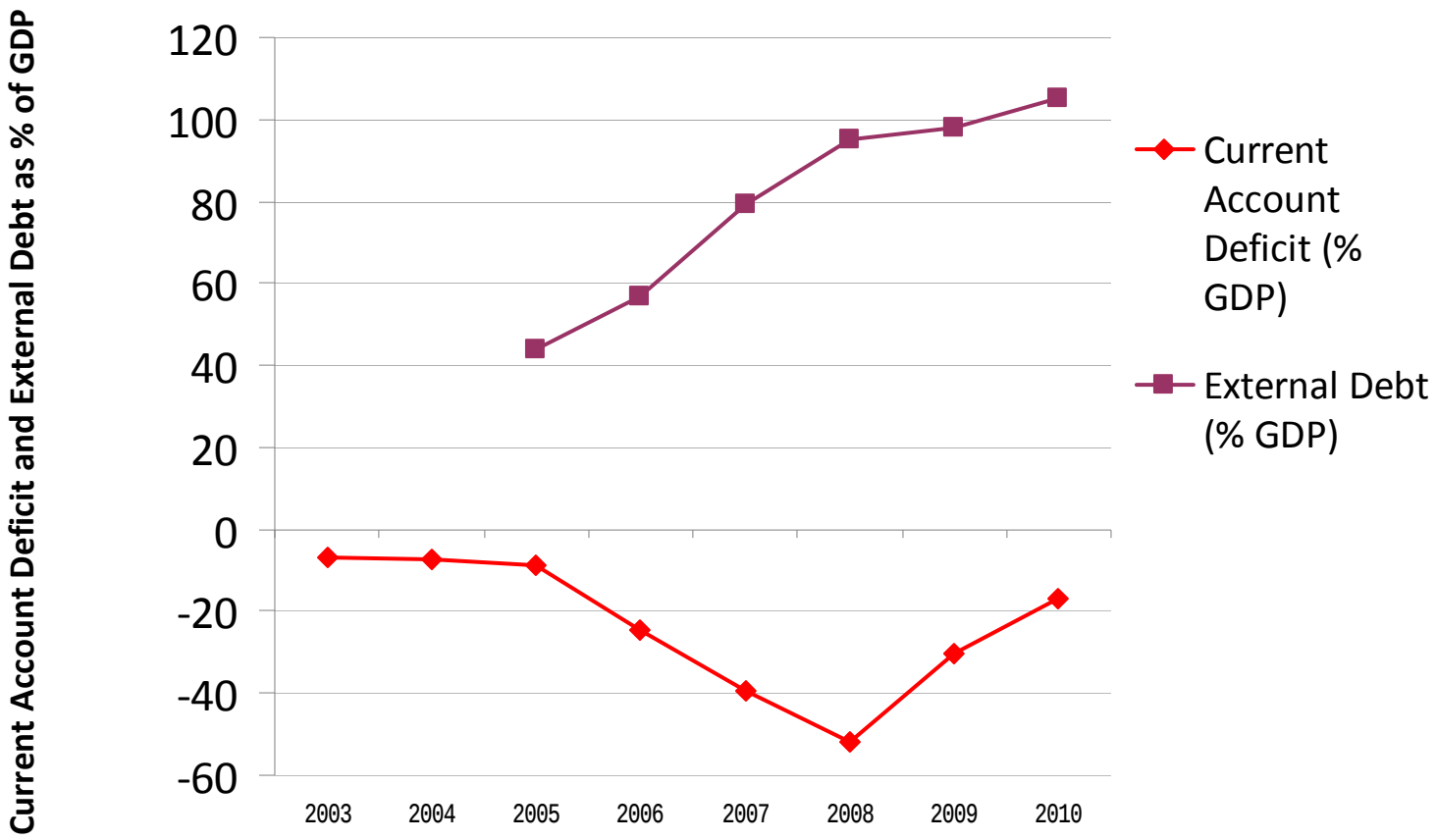
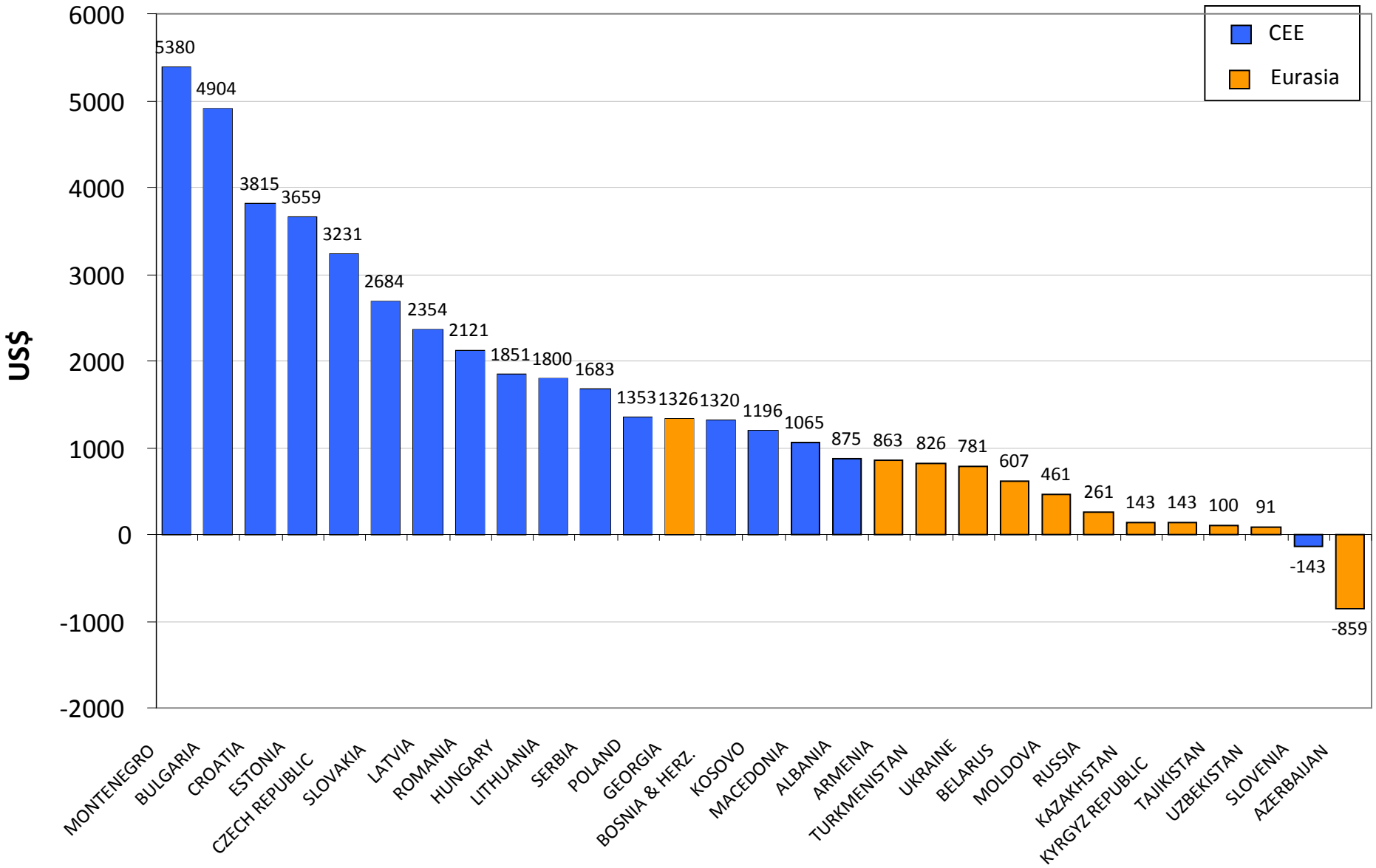
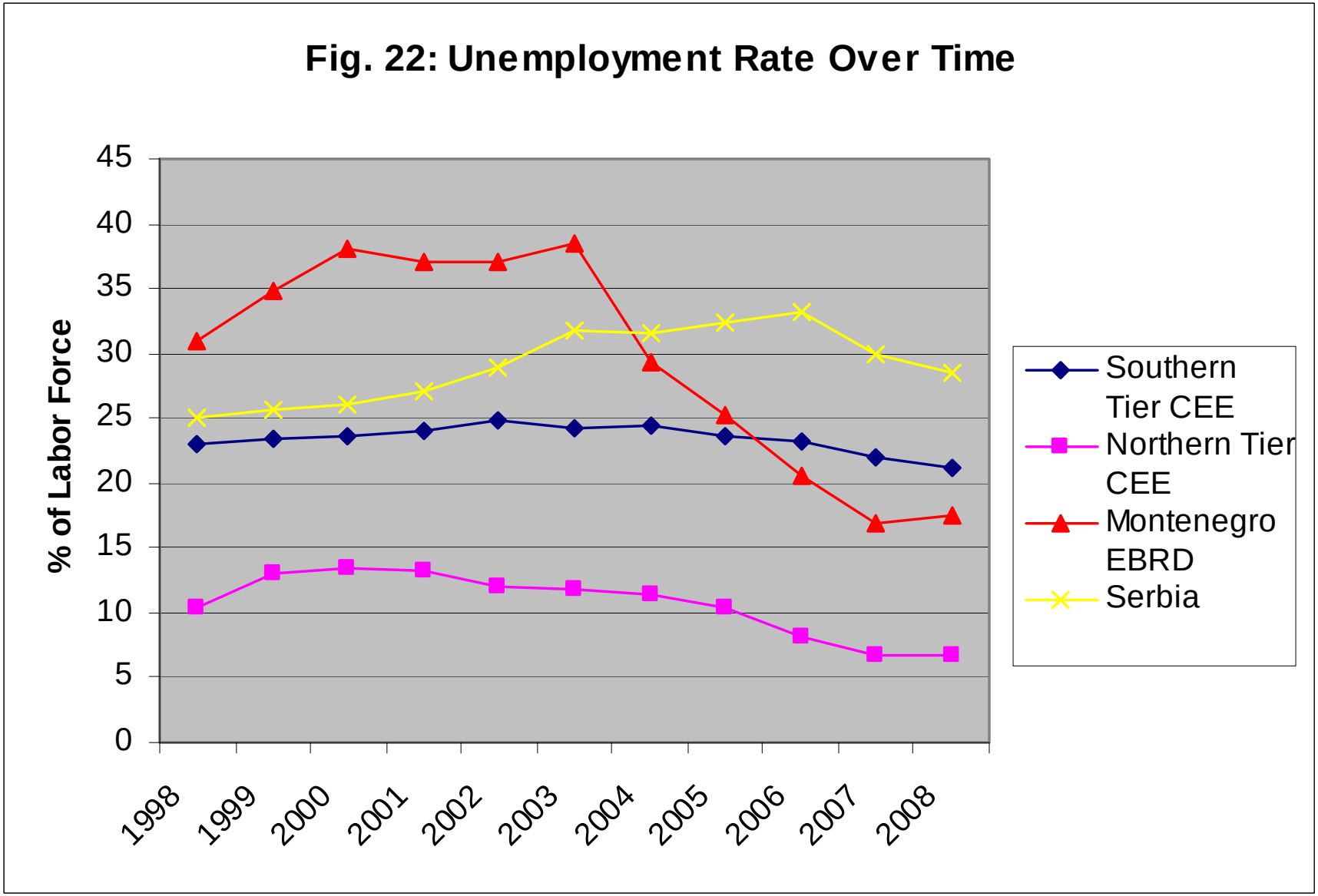


Fig. 21: Foreign Direct Investment

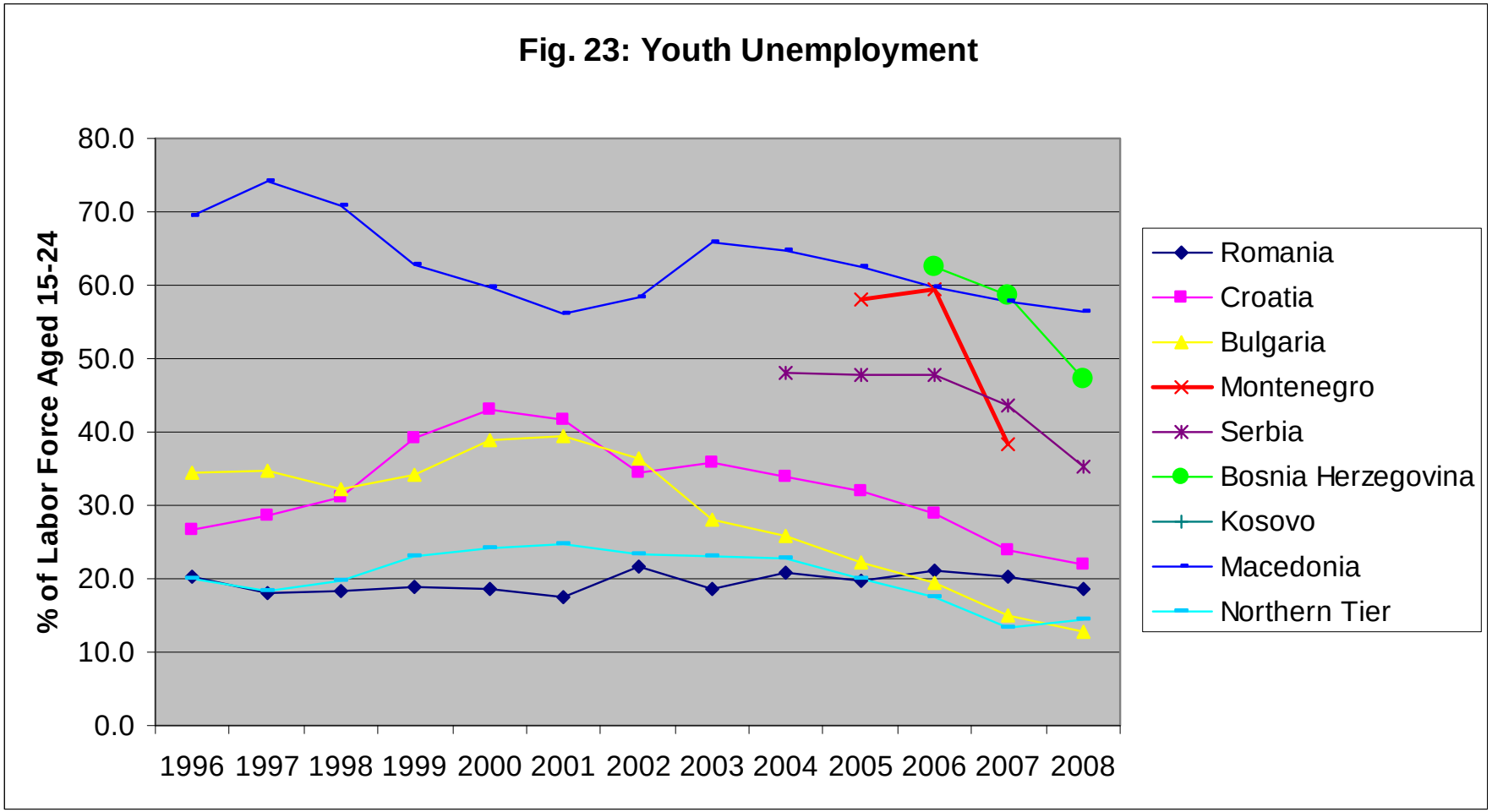
5 year cumulative per capita, 2005-2009



EBRD, *Transition Report* (November 2009).



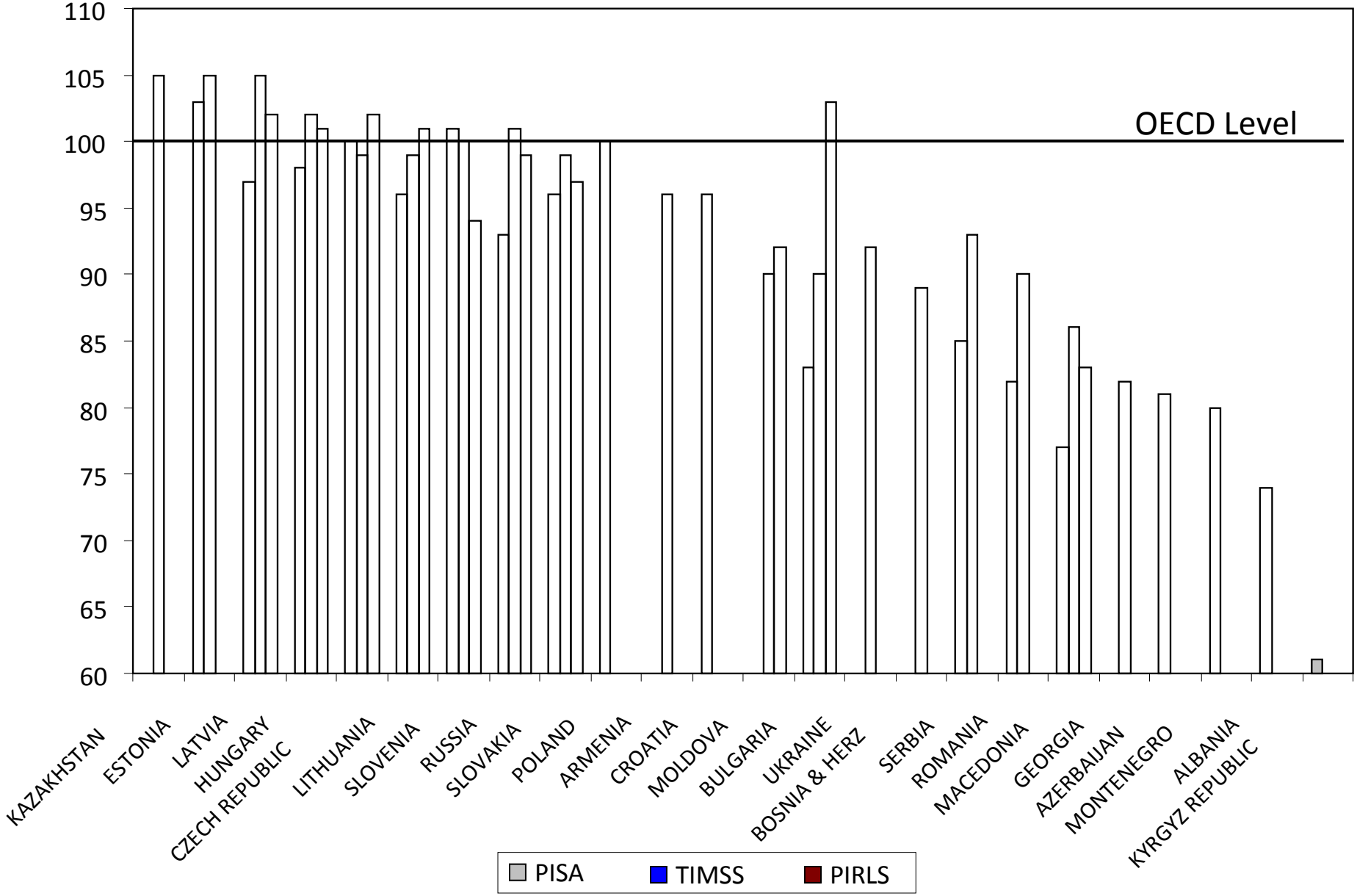
Source: EBRD, Transition Report (Country Assessments) 2009



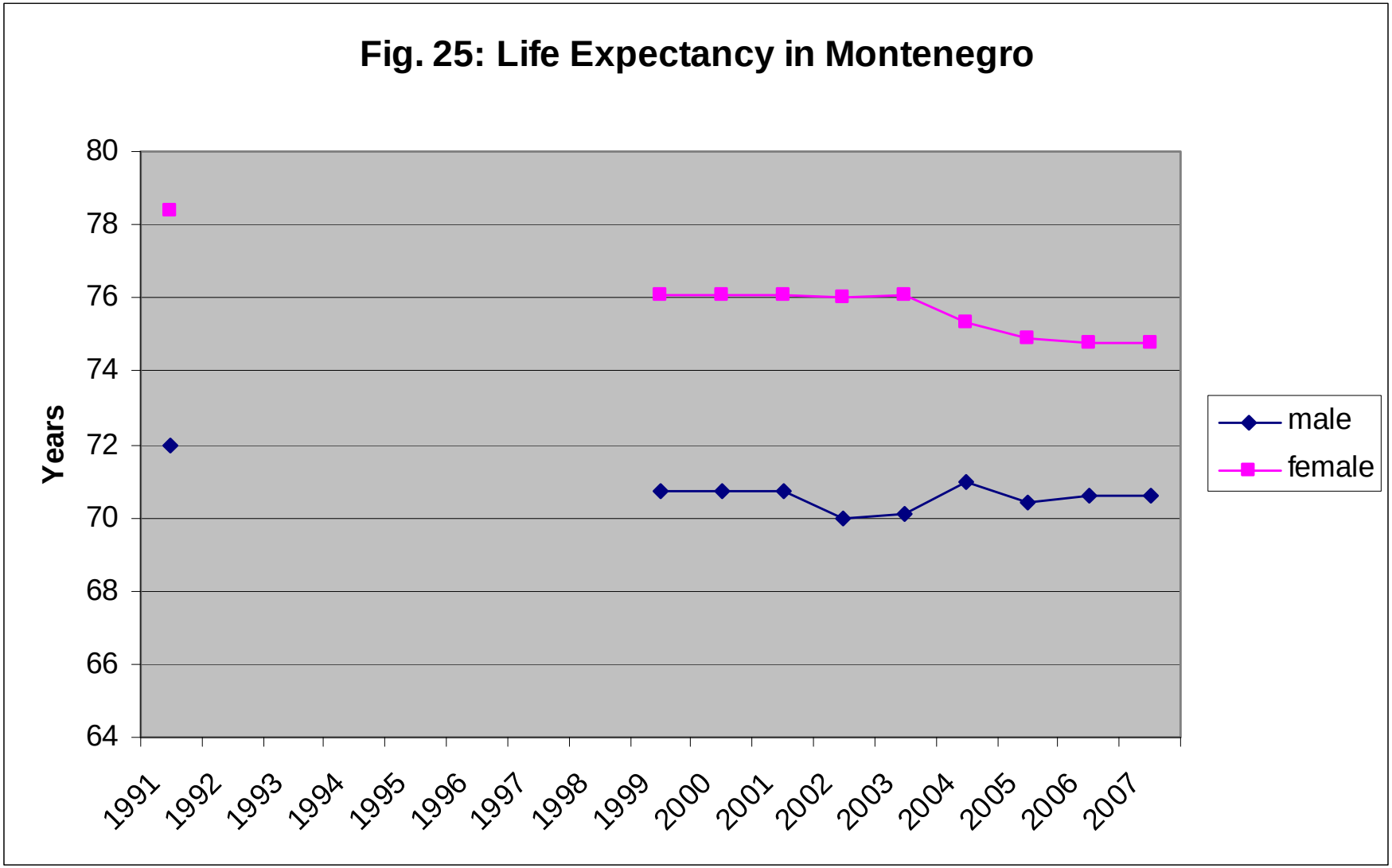
Source: UNICEF TransMONEE Database 2010

Fig. 24: Functional Literacy

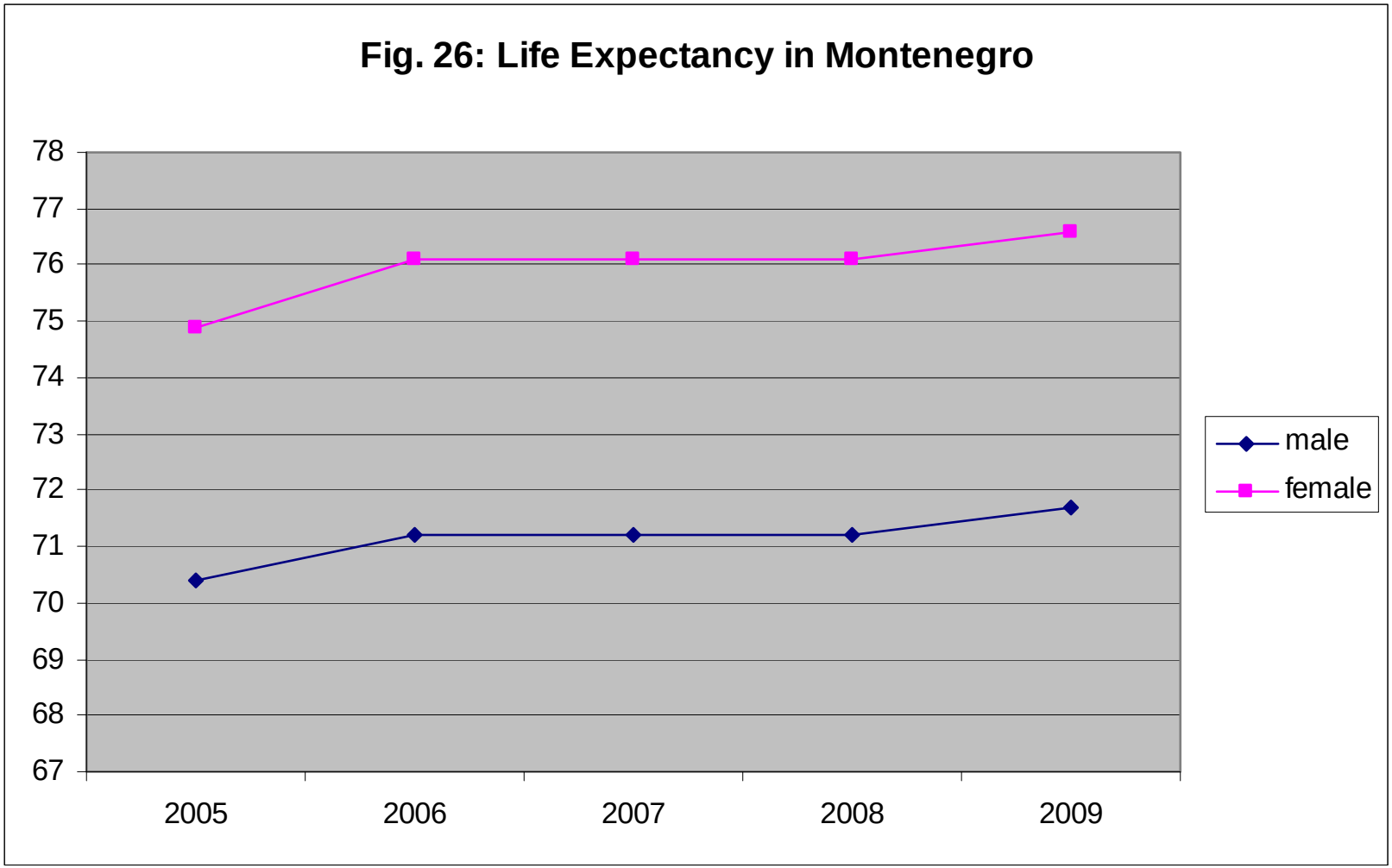
PISA vs. TIMSS vs. PIRLS



International Association for the Evaluation of Educational Achievement (IEA), *TIMSS International Mathematics Report* (2008), *TIMSS International Science Report* (2008) and *PIRLS International Report* (2008); and Organization for Economic Cooperation and Development (OECD), *First Results from PISA 2006* (2007).

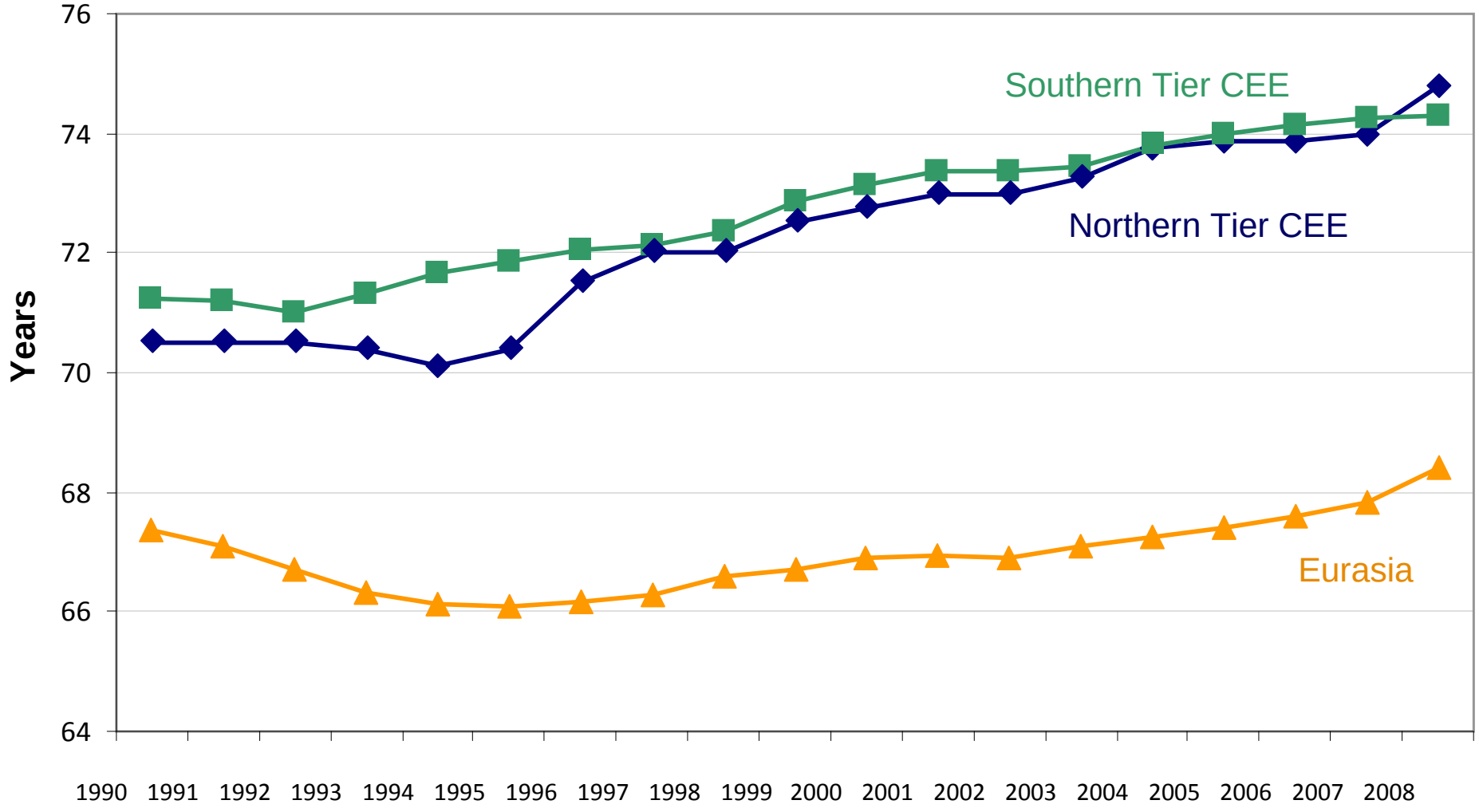


Source: UNDP Montenegro Human Development Report 2009

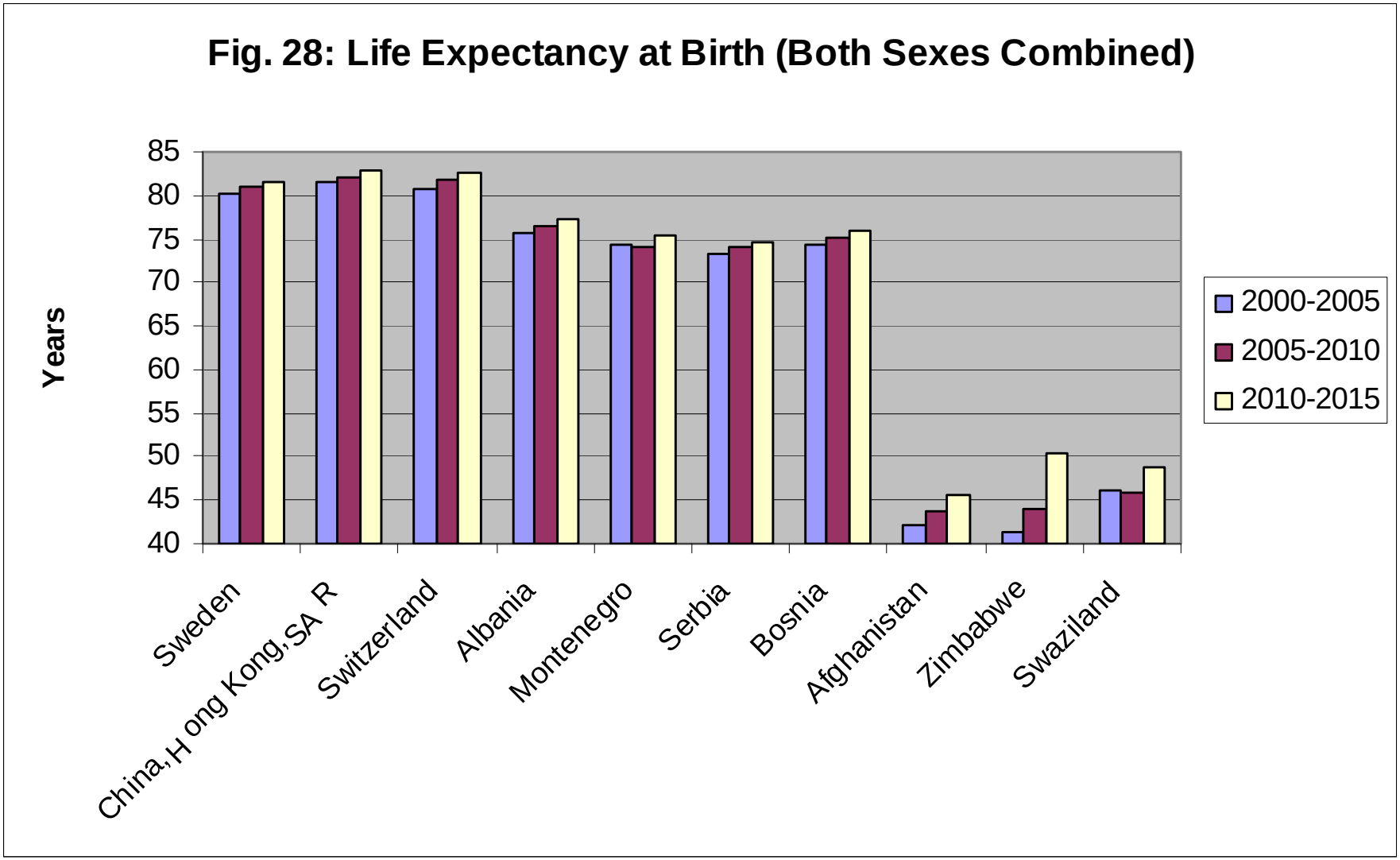


Source: MONSTAT 2010

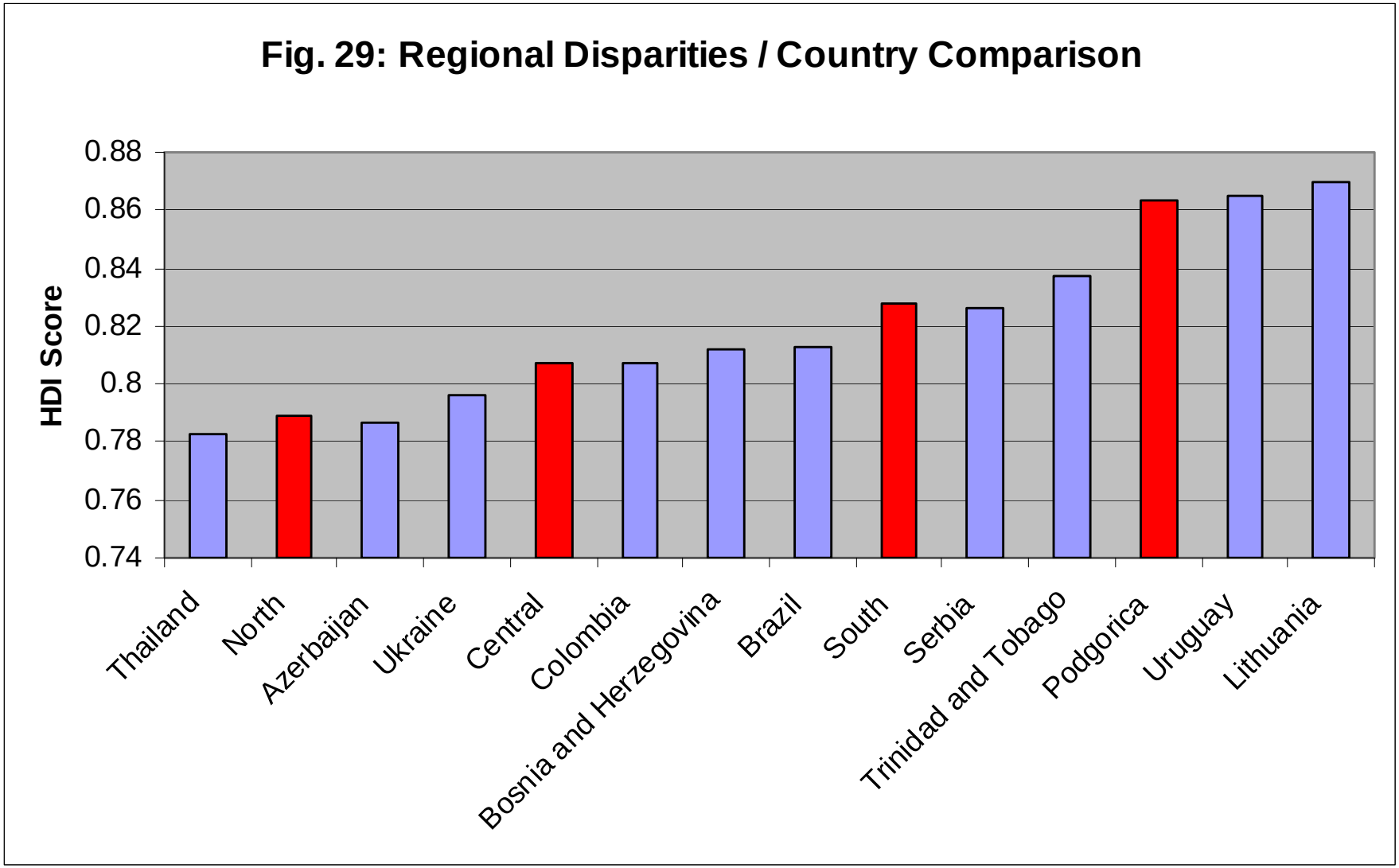
Fig. 27: Life Expectancy at Birth



World Bank, *World Development Indicators 2009* (May 2009).

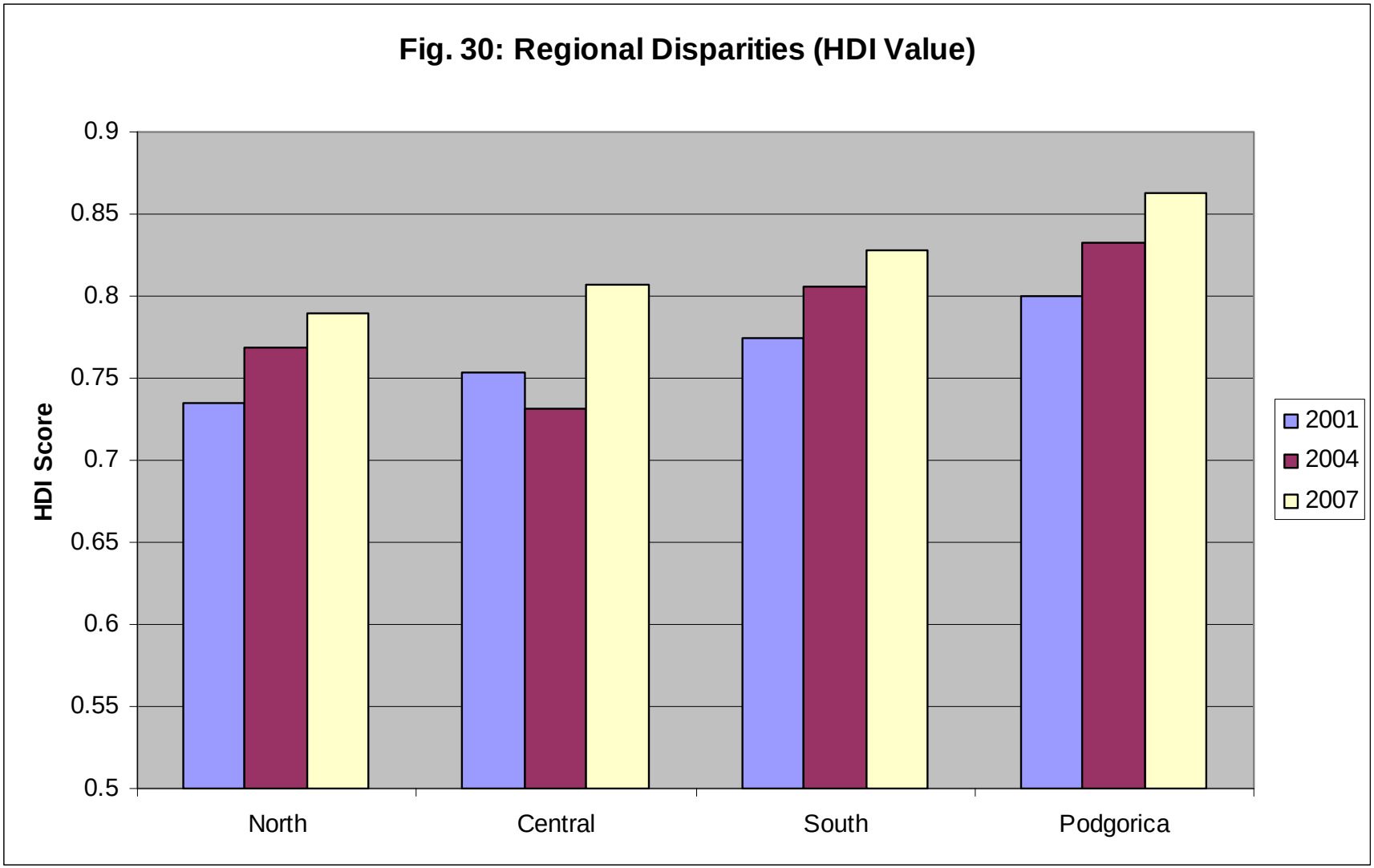


Source: UN Population Division: World Population Prospects: The 2008 Revision



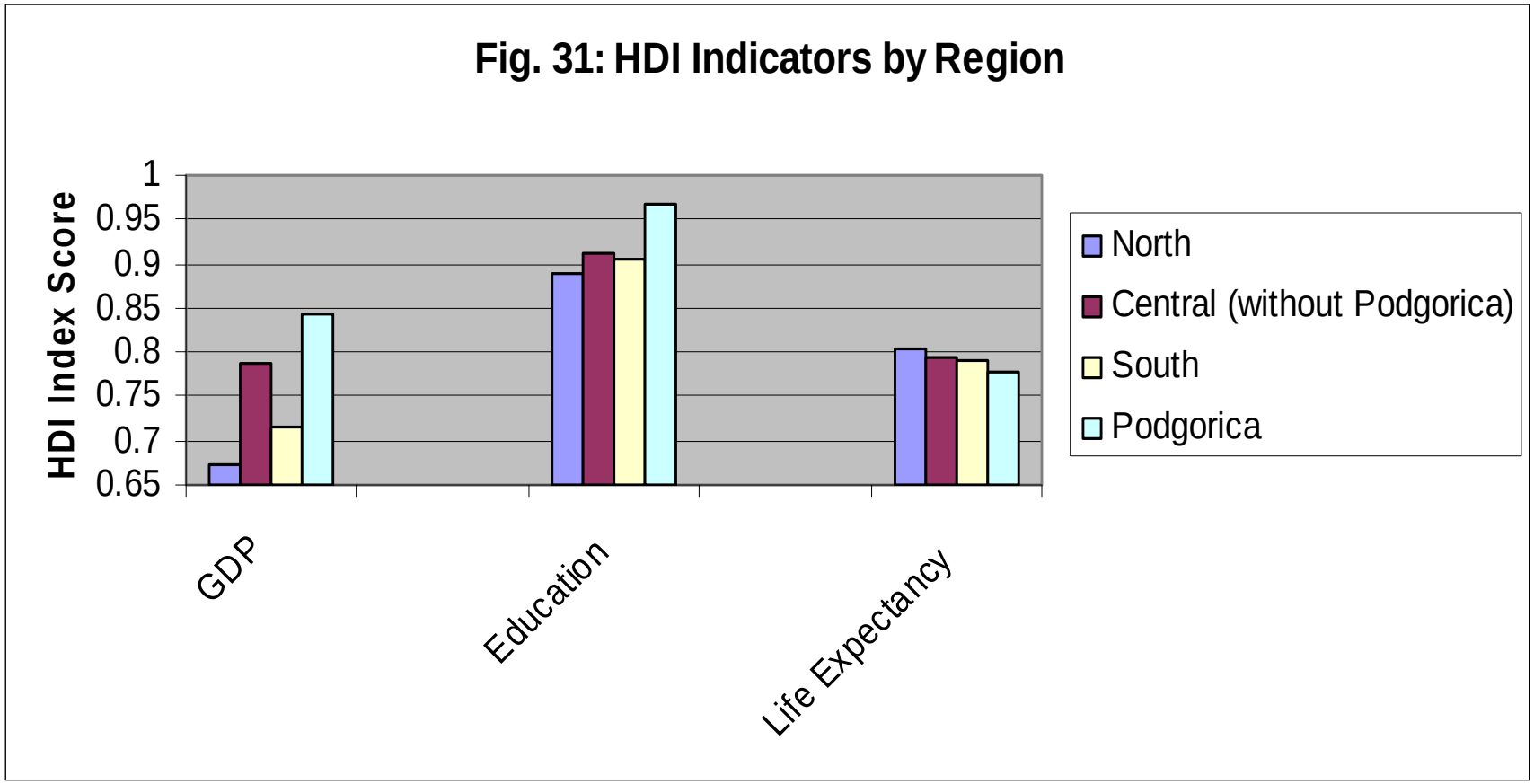
Source: UNDP, Human Development Report 2009, HDI Index Trends

HDI aggregate of 1. life expectancy (at birth as an index of population health and longevity, 2. education (adult literacy rate with 2/3 weighting and the combined primary, secondary, and tertiary gross enrollment ratio with 1/3 weighting and 3. per-capita GDP (as an indicator of standard of living).

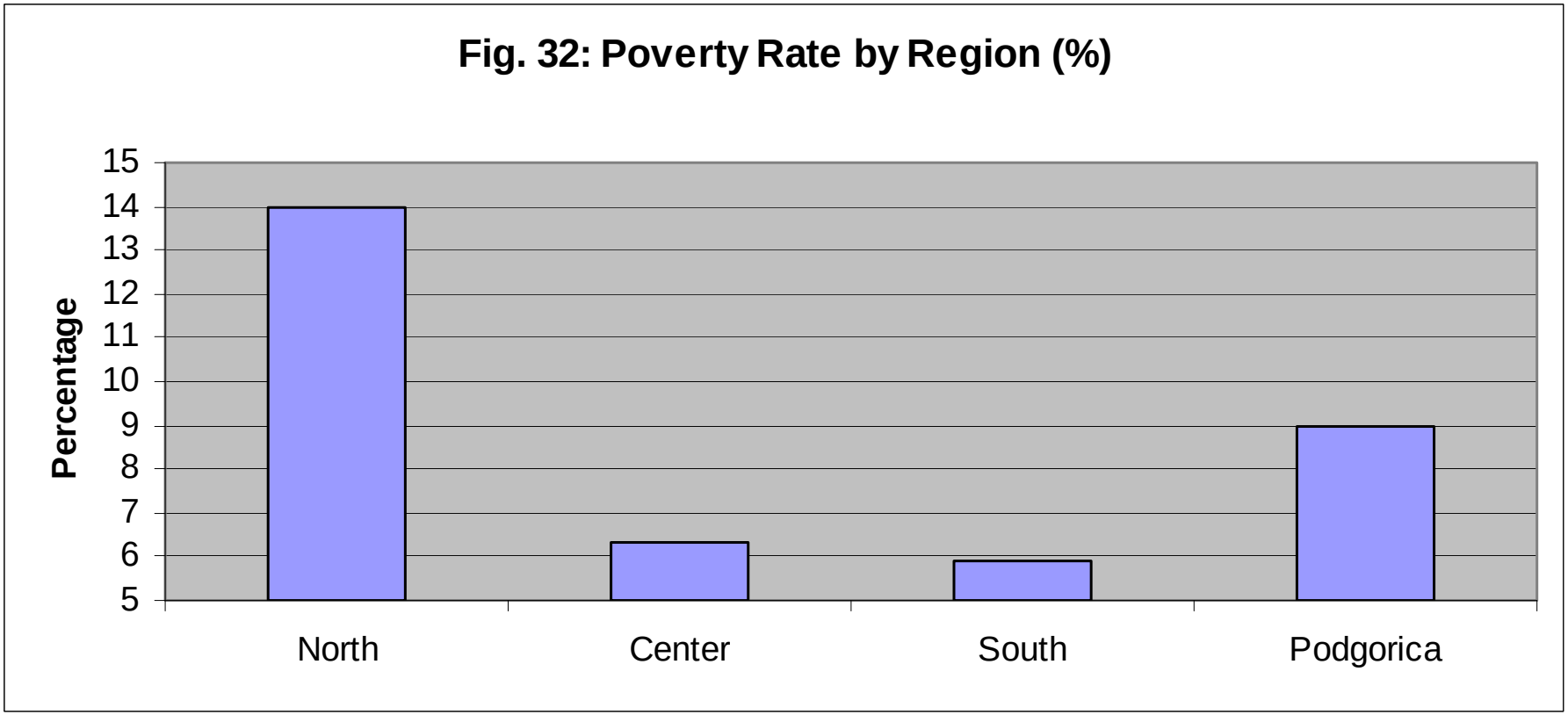


Source: UNDP Montenegro Human Development Report 2009

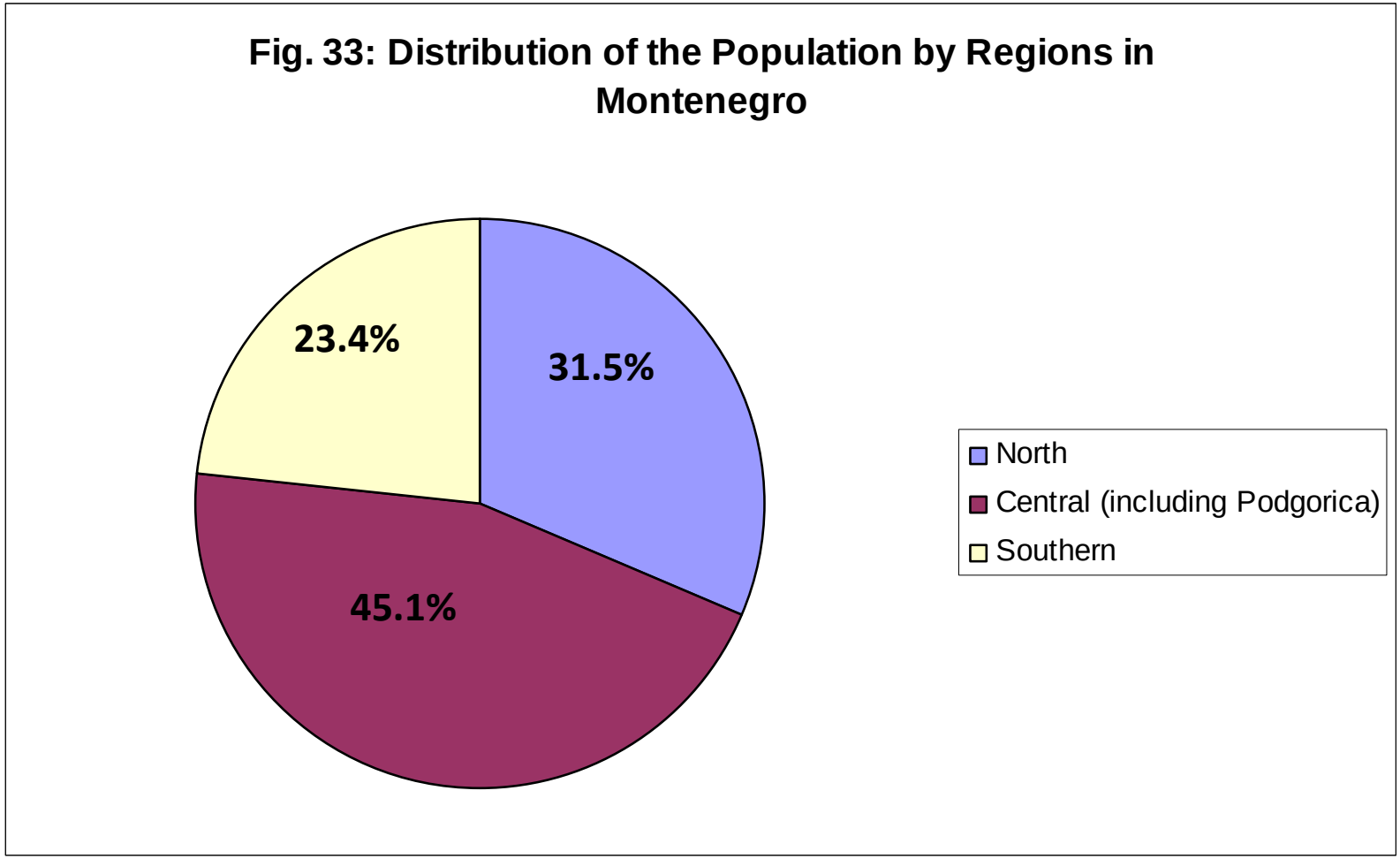
HDI aggregate of 1. life expectancy (at birth as an index of population health and longevity, 2. education (adult literacy rate with 2/3 weighting and the combined primary, secondary, and tertiary gross enrollment ratio with 1/3 weighting and 3. per-capita GDP (as an indicator of standard of living).



Source: UNDP Montenegro Human Development Report 2009

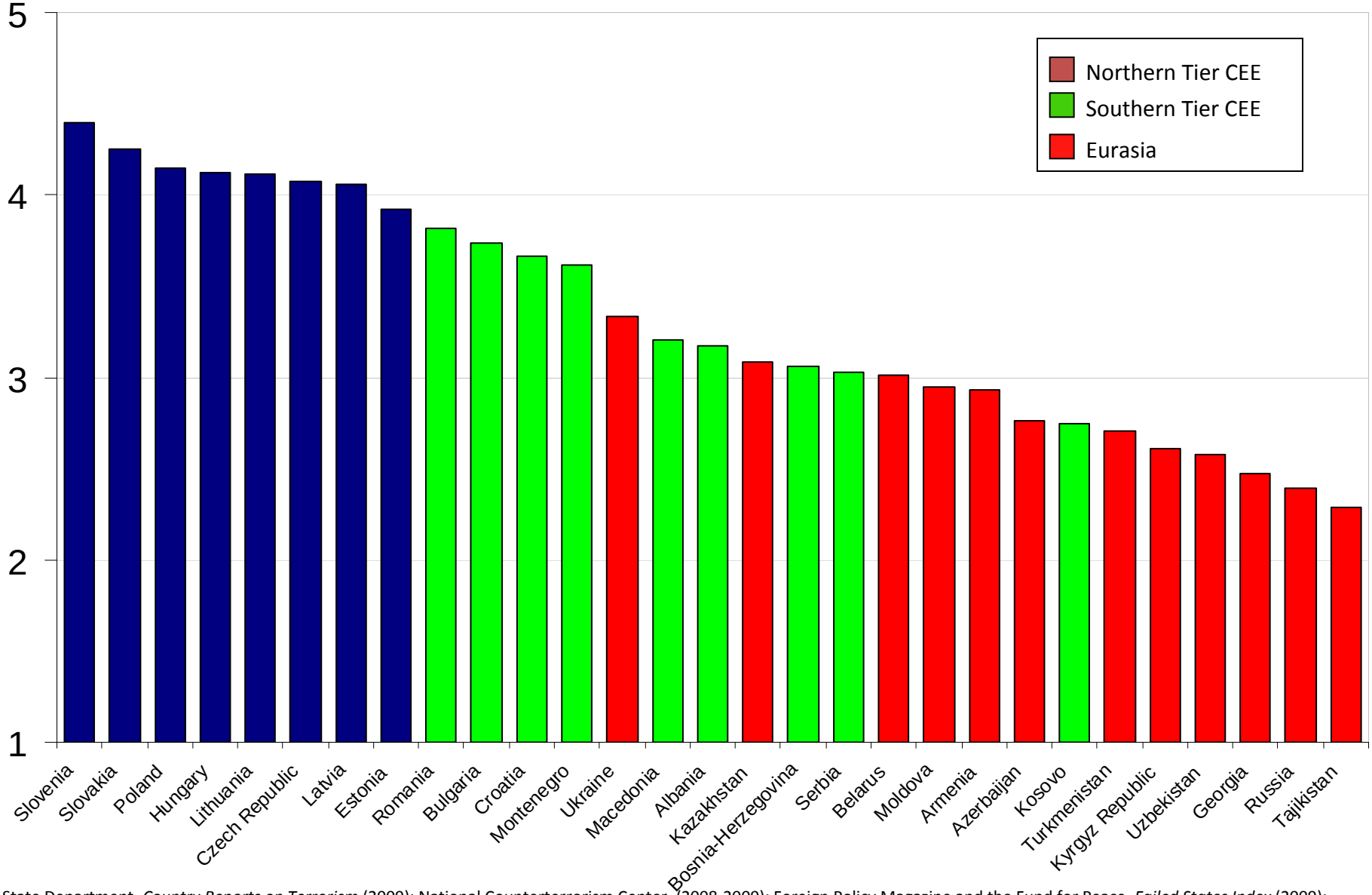


Source: UNDP Montenegro Human Development Report 2009



Source: UNDP Montenegro Human Development Report 2009

Fig. 34: Peace and Security in Europe & Eurasia in 2009



US State Department, *Country Reports on Terrorism* (2009); National Counterterrorism Center, (2008-2009); Foreign Policy Magazine and the Fund for Peace, *Failed States Index* (2009); World Bank Institute, *Governance Matters Indicators* (2008); US Commerce Department, *Export Control Policy,* (2009.) US State Department, *Export Control/Border Security Assessment* (2009) Binghamton University, Cingranelli-Richards *Human Rights Dataset,* (2007); UNICEF TransMONEE (2003-2006); World Bank, *World Development Indicators* (2009); A.T. Kearney/Foreign Policy Magazine, *Globalization Index* (2007) UNODC, *World Drug Report,* (2009) ; US Department of State, *Trafficking in Persons Report* (2009); USTR *Special 301 Report* (2009) ;US Department of State, *International Narcotics Control Strategy Report* (2009); Center for Global Policy, George Mason University, *Political Instability Task Force* (2006-0) USAID/DCHA/CMM *Instability Alert List* (2009)