

Montenegro's Currency and Foreign Trade Reforms:

A Brief Review

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Background

Montenegro has substantially liberalized its monetary-exchange and foreign trade regimes over the past two years. However, there is very little or no reliable, published information on these major policy changes and their implications.¹ While Montenegro recently developed a strong policy dialogue with the international organizations, their policy reviews available so far still tend to focus mainly on Yugoslavia as a whole, which in practice means largely Serbia, with comparatively little detail on Montenegro's reforms.² This brief communication attempts to fill that information gap: It provides a brief overview of these reforms and a very preliminary assessment as of end-2001.

The Currency Reform

Over the past two years, Montenegro has abandoned the use of the Yugoslav dinar and adopted the euro, in three steps. On November 2, 1999, Montenegro adopted the German mark as legal tender, parallel to the Yugoslav dinar. On November 13, 2000, Montenegro left the dinar monetary area by withdrawing the remaining dinars from circulation on its territory. Finally, on January 1, 2002, Montenegro begins the conversion of the German mark to euro, which will shortly thereafter become the sole legal tender on its territory. Therefore, in little over two years, Montenegro has changed its monetary-exchange regime from an adjustable exchange rate peg of the non-convertible dinar before November 1999, to a parallel currency regime—with the German mark co-circulating with and spontaneously replacing the dinar—

*Forthcoming in *Montenegrin Economic Papers*, No.1, Vol. 1, January 2002, Podgorica, Montenegro, pp.77-83. The author is an economist at the International Monetary Fund (IMF) in Washington D.C. The views expressed are those of the author, not necessarily those of the IMF or its member countries.

¹ Exceptions are Center for Banking, Finance, and International Economics (2002) and the monthly publication MONET (Montenegrin Economic Trends), and, most recently, an article that appeared in *Wall Street Journal* (Andrews 2002) reporting on the early results of the introduction of the euro in Montenegro.

² This is changing though, as reflected in the World Bank's on-going preparation of the first structural adjustment loan for Montenegro that may be approved sometime in mid-2002.

during the 12-month period between November 1999 and November 2000, and, finally, the currency regime using a foreign currency as a sole legal tender– the euro.³

Why did Montenegro adopt the mark/euro? The reasons were economic⁴ and political.⁵ Economic reasons–in which we are particularly interested in–had to do with the dismal performance of the Yugoslav dinar as a currency, while political reasons reflected Montenegro’s growing mistrust of federal government, her progressive estrangement from Milosevic’s policies starting in January 1997, and the consequent decision by the Montenegrin authorities to take control of some state functions that were previously in the federal domain (e.g., customs, foreign representation).

³ Contracts in other currencies are permitted but deutschmark/euro is used as the common currency in most international transactions.

⁴ On the economic reasons for Montenegro’s decision to leave the monetary area of the dinar and adopt the mark, see Bogetić and Hanke (1999).

⁵ On the political reasons for the split between Montenegrin and federal government, from the perspective of the Montenegrin analysts, see Vukilić and Čagorović (1996). A good review of the Serbian or federal views on the politics of Montenegro is provided by *Prizma*, a periodical of the Center for Liberal Democracy from Belgrade. Recently, a number of useful international publications appeared on the politics of Montenegro, published, for example, by the United States Institute of Peace (www.usip.org), International Crisis Group (www.crisisweb.org), Center for Strategic and International Studies (www.csis.org) (Washington), and the Center for Economic Policy Studies (www.ceps.be) (Brussels), which may usually be found on their websites.

The specific economic rationale behind the Montenegrin government's decision to abandon the dinar was increasing weariness of the decade-old policy of abuse of Yugoslavia's monetary authorities by the Milosevic's regime, which resulted in two devastating hyperinflations (in 1990 and the second highest hyperinflation recorded in history that lasted for two years in the 1992-93 period).⁶ Even before the break-up of the former Yugoslavia, the dinar was one of the world's weakest currencies,⁷ but in the 1990s, it practically lost all main functions of money—unit of account, medium of exchange, and the store of value—as the population and businesses started relying on the German mark in all except the smallest transactions.

True, until January 1997, the Montenegrin government was a willing, though relatively marginal accomplice in the National Bank of Yugoslavia's (NBY) policy of inflation, and some of its institutions and interest groups also benefited from the seigniorage revenues. However, after the political schism with Milosevic's regime, Montenegro was increasingly excluded from seigniorage revenues until NBY stopped shipping dinars to the National Bank of Montenegro.

The results of the adoption of the German mark have been predictable and basically positive: a significant decline in inflation and nominal interest rates, the elimination of the curb market for the dinar and the associated speculative activities that dominated daily life during much of the 1990s; also, there was a recovery of economic activity (Figure 1). The annual rate of inflation in Montenegro fell from 67 percent in 1999 to 24 percent in 2000, and it continued on a gradually declining trend in 2001. (By contrast, Serbia continued to use the dinar with the annual inflation rate twice as high as that in Montenegro.) Interest rates, previously in the range of 4-5 percent per month, dropped to 1-1.5 percent per month for the first time in more than a decade. With the hitherto most profitable occupation—speculation on the dinar-German mark exchange rate—losing economic sense, the citizens increasingly focused on other economic activities. From a slump in 1999 when output declined by 16 percent,⁸ growth recovered in 2000 to about 6 percent, despite a major deterioration in terms of trade. Since

⁶ See Bogetić, Dragutinović, and Petrović (1994) for a detailed account of this hyperinflation episode, and Petrović, Bogetić and Vujošević (1999) for an empirical analysis of the inflation process in that period.

⁷ Dean and Pringle (1994) noted that in the period 1971-91, the Yugoslav dinar was a currency with the second worst inflation and depreciation record, after the Brazilian currency. Also, see Hanke (1999).

⁸ The output decline in 1999 was heavily influenced by the NATO bombing campaign against Yugoslavia. While the campaign was targeting mainly Serbia, Montenegro being in the same country suffered severe economic consequences of the collapse of regional trade and the large influx of refugees.

Montenegro is now using the euro, as opposed to the dinar, it will no longer be subject to real or pseudo currency crises that characterized its old currency regime.⁹

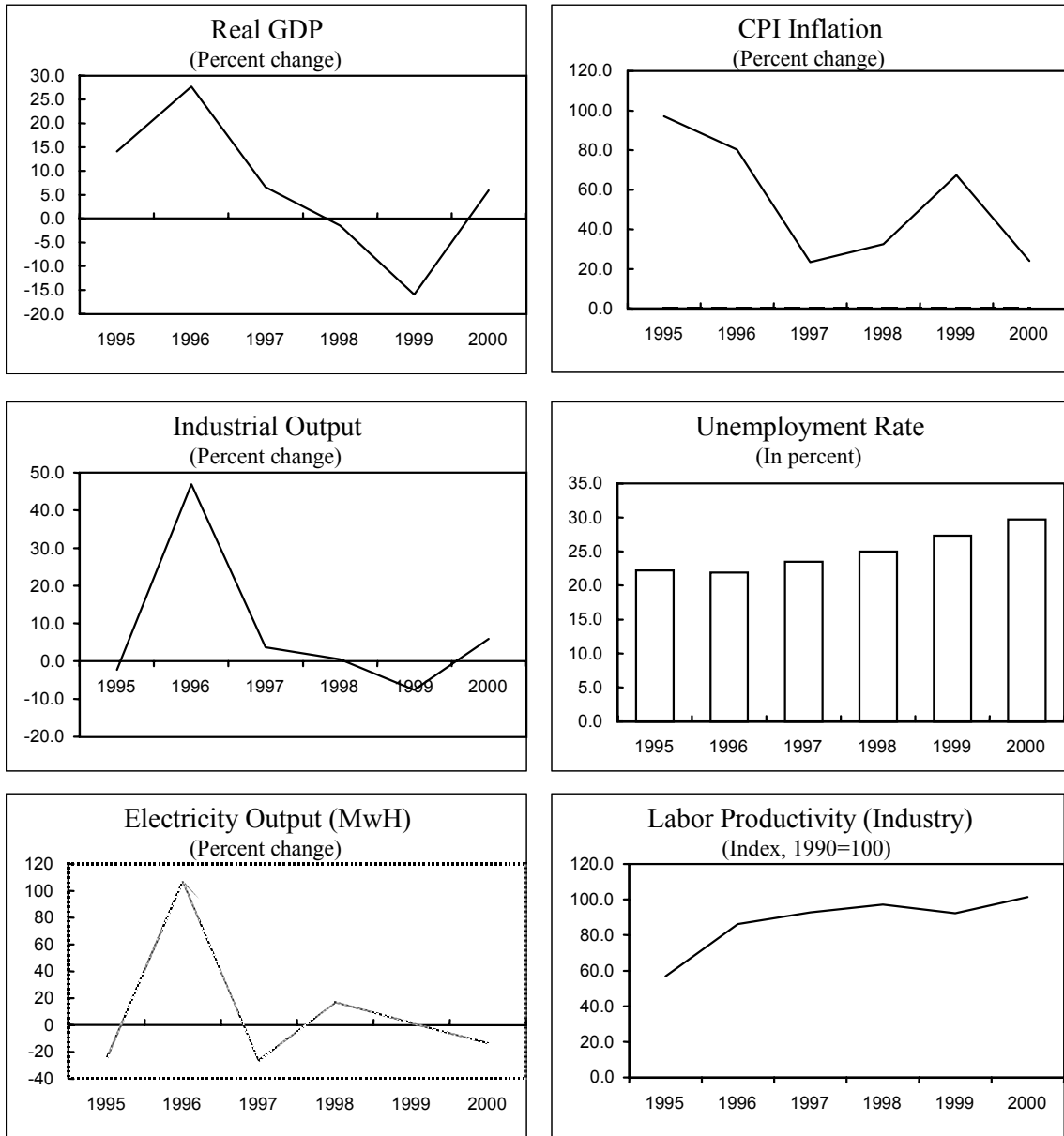
The adverse effects of this currency reform, which were predicted by several commentators in Belgrade, did not materialize. The possible short-term, adverse effects such as the disruption of trade flows and the functioning of the payments system associated with the shift to the German mark were minimal, since economic activity and regional trade were already severely disrupted by the NATO action. Also, the disruption in the payments system had to do more with political disagreements between the two republics than the technical problems in ensuring a smooth inter-republic payment system after Montenegro's introduction of the German mark.

However, the growth of wages in Montenegro, which exceeded productivity gains in this period—though not directly related to the currency reform—contributed to rising consumption, deteriorating current account, and slowing economic recovery; the fiscal situation also worsened. The increase in wages was a result of the usual political decision of the incumbent government in the run up to an election year, and pressures from the enterprise sector facing soft budget constraints. By the end of 2001, with the completion of elections of April 22 and the privatization process nearing its end, pressures for higher wages have moderated.

Overall, judging by the inflation performance, interest rates, the elimination of currency speculation, as well as a modest recovery of economic activity from the 1999 depression, Montenegro's adoption of the German mark in the narrow sense of a currency reform could only be termed as a success, especially considering harsh regional, security and economic environment. However, it should also be viewed as only the first stage of a large, unfinished reform agenda.

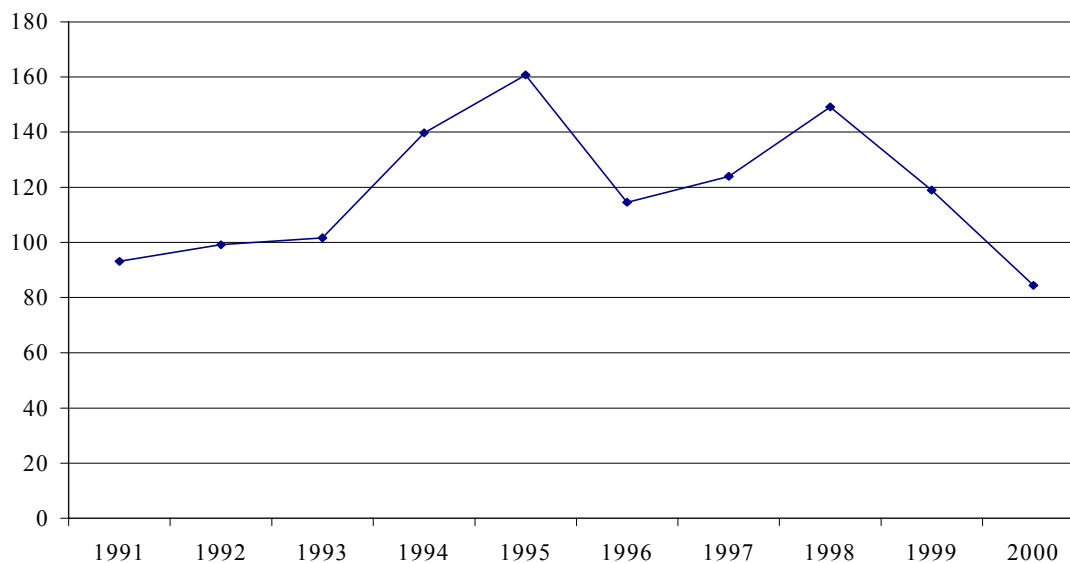
⁹ On the concept of real versus pseudo currency crises and some country experiences, see Hanke (2002).

Figure 1: Montenegro: Selected Economic Indicators, 1995-2000



Source: Center for Banking, Finance, and International Economics.

Figure 2. Montenegro: Terms of Trade
(Ratio of Aluminum and Oil Prices), 1991-2000



Source: International Financial Statistics, IMF, Washington D.C.

The broader question and a policy challenge that remains to be answered is whether the wage policy and fiscal policy will be strengthened significantly to avoid a further loss in competitiveness and prospects for rapid growth in medium term. Also, the speed and resolve with which the government will complete privatization and further improve business environment, and the Central Bank of Montenegro's efforts to clean up and strengthen the currently weak banking system will determine the long-term benefits of Montenegro's euro-based monetary-exchange and banking systems.

Foreign Trade Reform

Until recently, Montenegro had a highly restrictive foreign trade regime controlled by the federal government and, therefore, largely outside Montenegro's direct influence. The regime was characterized by high non-tariff barriers such as licenses and quotas. The tariff structure was opaque and restrictive. There were significant opportunities for corruption.

In June 2000, Montenegro significantly liberalized its foreign trade regime. The government adopted a temporary regulation taking over jurisdiction of customs from the federal authorities, pending the preparation of the new Customs Code in line with best international practice. According to the Temporary Act on Custom Tariffs, only Montenegrin laws and institutions regulate all international transactions. All customs rates, previously determined by the federal legislation, are now set by Montenegro's authorities. Importantly, the liberalization proceeded despite a substantial deterioration of external terms of trade, as

reflected in the movement of prices of Montenegro's key exports (aluminum) and imports (oil derivatives) (Figure 2).

This reform has significantly simplified Montenegro's trade regime by substantially reducing licenses, quotas and rates while simplifying the tariff structure. As a result, Montenegro currently has a considerably liberalized import regime with over 80% of its import on a free import regime (Figure 3). The remaining 20% of goods and services imports are on various types of license and quota regimes. Customs tariff rate structure is simple. Rates range from 0% to 5% for an estimated 90% of goods and services imported to Montenegro. Luxury imports and a limited number of other goods are subject to rates of between 10% and 15%. Montenegro's exports are mostly free of quantitative restrictions. In the first half of 2001, about 96% of exports were on a free export regime with licenses and quotas accounting for only 4% (Figure 4). Exports originating in Serbia and transiting through Montenegro for shipment to third countries face zero tariff rate. Center for Banking, Finance, and International Economics, a policy research center from Montenegro, (2002) has recently evaluated Montenegro's foreign trade regime on the basis of the standard international methodology and gave it a rating 4, on a scale of 1 to 10, (where lower number denotes more liberal trade regime).

Yugoslavia's foreign trade regime (applying in practice to Serbia) has also recently been liberalized and has received a favorable international rating of 5, which is based on an average tariff of 9.5%, a 0.5% customs inspection levy, the use of licensing requirements to restrict imports, a few quotas, and export duties on about 30 items. Yugoslavia's rating was reduced from 8 (lower number indicates lower degree of trade restrictions) in 2001 upon the removal of a substantial number of quotas.

Figure 3. Montenegro: The Structure of Imports by Import Regime, January-June 2001
(in millions of US dollars)

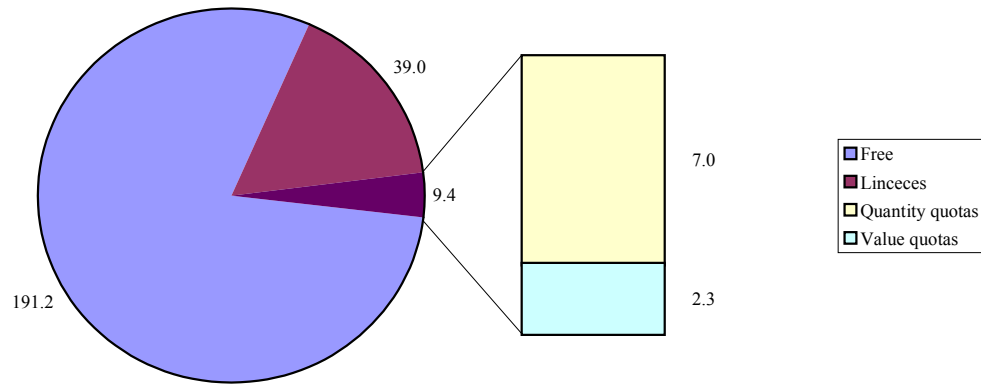
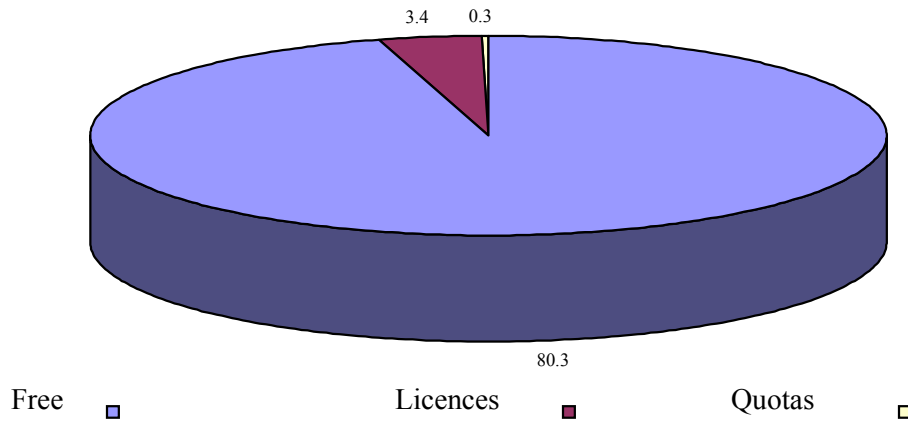


Figure 4. Montenegro: The Structure of Exports by Export Regime, January-June 2001
(in millions of US dollars)



Source: Center for Banking, Finance, and International Economic database.

Overall, despite harsh economic conditions, much has been accomplished in the liberalization of foreign trade. This bodes well for the recovery of foreign trade and the

overall economic activity. With further stabilization and economic recovery in the region, Montenegro could be poised for a rapid, foreign trade-led economic growth. To that end, the policy challenge is to maintain and improve competitiveness of Montenegro's products. This could be achieved by moderating wage increases in line with productivity growth, cutting red tape for importers and exporters, completing restructuring and privatization, and further liberalizing foreign trade and capital account regulations.

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