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Report

ACCESS TO FINANCIAL RESOURCES IN MONTENEGRO

- The Enabling Environment for
Sustainable Enterprises in Montenegro-



Title:

Report: Access to Financial Resources in Montenegro – The Enabling Environment for Sustainable Enterprises in Montenegro

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For publisher:

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Place and date of publication:

Podgorica, May 2016



International
Labour
Organization

This publication has been published with the (financial) support of the (Bureau for Employers' Activities of the) International Labour Organization.

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Purpose of the document

Through comprehensive and complex survey, using a global methodology of International Labour Organisation (ILO) for enabling business environment, Montenegrin Employers Federation (MEF) recorded the existing business barriers in Montenegro and then identified those that, according to employers, represent 5 key “business killers”. According to the survey, one of the “killers” is difficult access to financial resources (FR).

The basic purpose of the document, based on MEF strategic documents – a report *The Enabling Environment for Sustainable Enterprises in Montenegro and 5 business killers* (2013), as well as the thematic research through focus groups discussion that MEF carried out in early 2016, is to present the possibilities of accessing financial resources to the companies in Montenegro that need it as well as to define the causes of difficult access to FR and offer recommendations for addressing or alleviating the problem.

This document was being created from March to July 2016. For the purposes of this document, we used data from various sources: state institutions official reports, conclusions from focus groups participants, interviews, domestic and foreign literature, anonymous online questionnaire using a random sample of employers and MEF documents. The data of all state institutions were available but since we did not manage to get original data from the Investment-Development Fund of Montenegro, we used the available data from their official website along with information from printed and electronic media.

Executive Summary

Difficult access to FR is the problem mostly faced by small and medium sized enterprises (SME). The results of the Survey have shown that more than 80 per cent of SMEs in Montenegro face this problem.¹

Moreover, difficult access to FR influences SMEs to turn to informal financial resources (65 per cent of SMEs surveyed).

Montenegro is one of the better ranked countries in the region when it comes to access to FR, but still far behind from developed countries. In developed countries the portion of SMEs which face difficulties accessing FR varies from 15 to 30 per cent (OECD, 2016) while the share of SMEs facing the same problem in Montenegro is over 80 per cent. The access to FR is the most problematic for small companies with 1 to 9 employees, which according to EU classification belong to micro enterprises.

In Montenegro, SMEs can obtain FR from the following external sources:

- Banking sector: commercial banks and micro-financing institutions
- Investment-Development Fund of Montenegro (IDF)
- European Bank for Reconstruction and Development (EBRD)
- Other sources (international support programmes).

Internal sources (personal resources) are very narrow and limited to the money and other resources derived from personal or family property. Informal resources are also used to a large extent, that later on complicate company's financial position i.e. they distort the true picture of the company's situation since personal borrowing is used for financing business with no legal and bookkeeping relations between these two. Very often, employers tend to borrow money on the black market.

There are various factors that affect the access to FR, at both supply and demand side. Limitations can be found in the legal infrastructure and inefficient public administration.

According to **employers** (demand side), the main causes of difficult access to FR are:

- High interest rates on domestic banking market,
- Aggressive baking policy when it comes to securing loans,

¹ For the purpose of this report, in March 2016, the author conducted a survey using the sample of 130 small and medium sized enterprises (from Podgorica and Niksic) from the databases of credit portfolios of several banks in Montenegro.

The survey was based on a simply designed questionnaire with an aim to get a general picture of the access to financial resources and it contained 6 questions (with 3 choices of answers offered: 1. YES, 2. NO, 3. NO OPINION):

1. Are you satisfied with the way bank deals with your requests for loan?
2. Do you use private loans for running your business?
3. Do you have enough property to offer as collateral for requested loans?
4. Do you think that the Investment-Development Fund should fund SMEs directly?
5. Is the interest rate of banks too high?
6. Has the access to financial resources improved over the last 24 months?

The survey may be considered reliable in terms of the answers that were received. However, it does not have the analytical-statistical trustworthiness since it was not conducted by using standard scientific-statistical tools (questions classification, stratified sampling etc.).

- Inadequate structure of financial products offer on the market,
- High rate of declined requests for other reasons.

Such answers of employers indicate that their perception was mostly concerned with external sources of financing.

According to **banks** (supply side), the most significant problems affecting their lending decisions are:

- A rigid regulatory framework set by the Central Bank of Montenegro (CBM) as a result of compliance with international banking standards,
- Bad credit history (irresponsible use of earlier loans),
- Unreliable financial statements of a company (optional revision),
- Slow procedures of legal protection of the creditor i.e. the bank,
- Considerable illiquidity of economy.

Problems pointed out by both employers and banks, concerning business environment and **infrastructure**, are:

- Unreliable cadastral registry,
- Inadequate legal protection of the creditor,
- Slow judicial process - courts proceedings for debt collection take time
- Credit registry that is not updated
- Very shallow capital market.

The problem of access to FR is extremely complex and can be solved only with active participation of the state and international institutions authorised to support EU candidate countries. The basic recommendations suggest solution should be sought through the improvement of economic system structure by:

- reducing external trade deficit (imports substitution),
- increasing foreign investments,
- active participation of the CBM in the lives of banks
- affirming entrepreneurship,

as well as through a series of concrete actions towards:

- Strengthening the role of IDF,
- Establishing an SME bank,
- Developing alternative sources (ways) of financing (factoring, leasing),
- Establishing a guarantee fund that would provide support to SMEs,
- More active participation of the Government and international partners in financing SMEs,
- Improving (speeding up) the process of extrajudicial settlement of liabilities,
- Enhancing the application of mortgage right principle.

1. INTRODUCTION

Difficult access to financial resources (FR) is a gap between supply (banks) and demand (employers) for money in a certain infrastructural circumstances (a state). In order to determine the size of the gap, its nature and the possibilities for overcoming it, we have to analyse the causes of one or more of such phenomena. It is extremely hard to do in practice since sometimes it is impossible to distinguish the cause and the effect of certain phenomenon.

According to OECD, the availability of financing sources for SMEs is determined by the following factors: 1) country's overall legal, institutional and regulatory framework, 2) the availability of skills, knowledge and information about the potential sources of financing SMEs, 3) an adequate mixture of financial instruments and institutions available to SMEs within reasonable time frame.

There are numerous reasons that make SMEs access to FR much harder in comparison to large companies. Unlike large companies, that have the access to capital market, for the majority of SMEs the capital market is unavailable so the resources have to be sought from other sources, most often from loans.

The term *SME* comprises three groups of enterprises according to international institutions classification: micro (1-9 employees), small (10-49 employees) and middle (50-250). It is why the often found abbreviation in literature is SMME instead of SME.

The share of SMEs saying they face problems accessing financial sources is far beyond global average in middle developed and developed countries. Over 80 per cent of SMEs say they face difficulties in getting loans and think their access to financial resources has not improved but, on the contrary, it has even worsened over the last 24 months. The figure is much worse compared to 30 per cent of SMEs in middle developed or 15 per cent of SMEs in highly developed countries that see poor access to financial sources as main obstacle to their development. (Financing the Growth of Small and Medium Sized Enterprises, USAID Serbia, 2012)

The most significant creditor i.e. financing source for SMEs in Montenegro are banks and, regardless the potential affirmation of other creditors in the future, the banks will remain one of the most important partner of SMEs for a long time, at least only for the need to service the current loans, which very often imply refinancing of the existing loans.

The needs for capital and the availability of financing sources change depending on the company's life cycle stage. Companies go through the following stages of its life cycle: start up, growth and development, and shutting down. The characteristics of a company are different in each stage and managing those changes requires different skills, structures and resources.

In the initial phases, small companies usually rely on personal resources while the use of external resources becomes more important in later stages when companies' needs for capital go beyond owners' capacities. Financing by borrowing money from banks and other financial institutions is very expensive for SMEs whereby the problems are more characteristic for the

first stage of development when entrepreneurs, on one side, try to maintain their stable financial position by avoiding the payments while banks, on the other, are not willing to borrow to those companies with bad credit history.

Entrepreneurs, by rule, do not have enough knowledge in the area of financial management which is the reason why their decisions are not always optimal. Entrepreneurs, owners and managers usually possess knowledge and skills in the area of company's operations but they are not properly acquainted with different aspects of financial management. It is why it happens very often that an entrepreneur ends up in the vicious circle of frequent loans, using a new loan to compensate for prior bad decision (refinancing circle) making an additional increase of expenditures at least by the amount of previously unpaid interest rate, that is added to the loan principal.

SMEs clearly have the greatest tendency to change which enables a wider dispersion of general risk. Social sustainability of one society i.e. of one state is largely dependent on vitality and mobility of SME sector which is why governments pay due attention to sustainability and development of SME sector.

1.1 Entrepreneur –Importance and Role of Entrepreneurship

Going into business starts with an idea. There are plenty of definitions of *entrepreneur* in literature and each one of them essentially explains the same feature. An entrepreneur is an individual that has the idea for starting a business or for advancing its current business. According to D. Lajovic an entrepreneur is usually defined as “a person who starts new businesses, and independently organises and controls the business process. He/she creates new business opportunities despite risk and uncertainty with an aim of making the profit and achieving growth. He/she thereby identifies favourable opportunities and collects necessary resources to make profit out of them. An entrepreneur is an innovator i.e. an individual that creates something unique. His/her function is to reform and produce in a revolutionary way. An entrepreneur generates new goods or creates old ones in a new way using innovations or introducing new technological methods. He/she strives to find new sources of raw material or new opportunities for products placement i.e. he/she organises the production process in a unique and his/her own way.” Such a broad definition clearly suggests the importance of entrepreneur for society as a whole. As estimated by experts dealing with this topic, the share of entrepreneurs in society is merely around 2 per cent. It gives additional importance to entrepreneurs and entrepreneurship in general since we are talking about a very small number of people in a society or a country.

It is the reason why the objective of every society or state should be to create better conditions for realisation of entrepreneurial ideas. One of the conditions is an easier access to financial resources. According to the above said, an entrepreneur is a person that shows up where the risk is to be taken or resources invested in order to create something new or to achieve something that already exists, in a new way. An entrepreneur generates growth and development since his/her idea, if realised successfully, generates new jobs and country's GDP growth. An entrepreneur is an individual who, very often, is not capable of realising his/her idea alone so he/she addresses financial institutions for the missing financial resources. Whether

entrepreneur will start to realise of his/her idea and to what extent usually depends on the availability of FR.

The entrepreneur willing to start the investment has to define the structure of resources that will finance his/her entrepreneurial idea. Usually a personal share (capital) is combined with a loan (long-term or short-term loans). The availability of FR when the entrepreneur does not have enough capital is in vital interest of the entrepreneur and in nothing lesser of the state.

The entrepreneur is a driver of development. Without entrepreneurial idea, there are no investments. Without investments, there is no growth. So, encouraging investments should be the ultimate objective of every public administration in order to have a strong basis for maintaining societal upgrade in the form of necessary public administration and structure and higher living standards. If an entrepreneur is denied the possibility to realise his/her idea, then an entire society loses since the opportunity for creation of new jobs and i.e. creation of new values has been lost.

The realisation of entrepreneurial idea affects whether there will be new jobs i.e. whether the number of unemployed dependant on social funds will decrease. The (un)employment rate influences the level of economic activity, economic growth and development, and consequently, all macro-economic aggregates.

1.2 Structure of Enterprises – Basic Data (Demand Side)

In Montenegro, enterprises are divided into small, medium and large, depending on the average number of employees, the overall annual turnover and the overall value of assets.

Middle legal entities involve those legal entities that on the day of financial statements preparation satisfy two of the following three criteria:

- To have an average number of 50 to 250 employees in a year they submit a financial statement for,
- To have an overall annual turnover from 10 to 50 million EUR,
- To have an annual balance sheet total from 10 to 43 million EUR.

Legal entities having two out of three criteria lower than the lowest values mentioned above are classified as small legal entities and legal entities having two out of three criteria higher than the highest values mentioned above are classified as large legal entities.

We can say that the structure of enterprises by size in Montenegro is identical to EU's. Small and medium sized enterprises (SME) are the backbone of European economy, since they generate 66 per cent of employment and two of three jobs in the private sector. Montenegrin economic structure is very similar. SMEs contribute with 67 per cent to the overall employment while large companies employ 23 per cent of the total number of employed. SMEs contribution to Montenegro's GDP (in 2013) was 72 per cent (Statistical Yearbook 2015, MONSTAT). SMEs contribute with 45 per cent to the overall exports of Montenegro.²

² National Agency for SME Development, <http://nasme.me/wp-content/uploads/2013/09/O-direkciji.pdf>

EUROSTAT data of March 7, 2016 reveal that by the end of 2012 there were 22.346.729 enterprises (without taking into account the enterprises from the financial sector) in EU (28 member states). Of that number, only 0.2 per cent (43.590 companies) is enterprises with 250 and more employees. As much as 92.7 per cent (20.717.621 companies) of the total number are companies with up to 9 employees. This is more than a sufficient indicator that SMEs have huge multilayer importance for EU economic and social stability. If to that we add a fact that around 66 per cent of the total number of employed in private sector in EU works in SMEs then this statement may be taken as axiom. (European Commission (2014d))

The number of business entities in Montenegro in 2015 was 25,955, 10.2 per cent higher than in 2014 when that number was 23,308.

Table 1: Business Entities by Municipality, in 2014 and 2015

MUNICIPALITY	FREQUENCY 2014	PERCENTAGE	FREQUENCY 2015	PERCENTAGE
ANDRIJEVICA	52	0.2	64	0.3
BAR	2352	10.1	2614	10.1
BERANE	437	1.9	465	1.8
BIJELO POLJE	863	3.7	959	3.7
BUDVA	2688	11.5	3021	11.6
CETINJE	521	2.2	599	2.3
DANILOVGRAD	393	1.7	446	1.7
GUSINJE	1	0.0	6	0.0
HERCEG NOVI	1879	8.1	2132	8.2
KOLASIN	186	0.8	195	0.8
KOTOR	1043	4.5	1153	4.4
MOJKOVAC	130	0.6	139	0.5
NIKSIC	1520	6.5	1675	6.5
PETNJICA	1	0	8	0
PLAV	90	0.4	99	0.4
PLUZINE	496	2.1	552	2.1
PLJEVLJA	28	0.1	33	0.1
PODGORICA	8255	35.4	9350	36.0
ROZAJE	469	2.0	521	2.0
SAVNIK	22	0.1	24	0.1
TIVAT	945	4.1	950	3.7
ULCINJ	825	3.5	850	3.3
ZABLJAK	112	0.5	100	0.4
UKUPNO	23 308	100.0	25 955	100.00

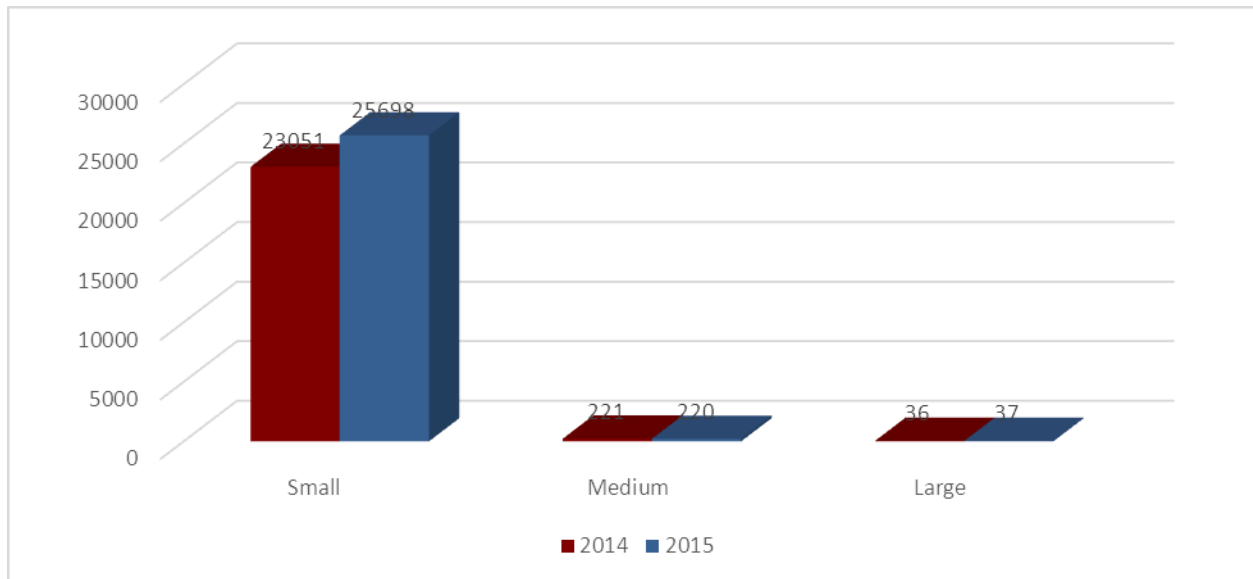
Source: MONSTAT, Analysis of number and structure of business entities in Montenegro in 2015, March 2016

If we look at the number of business entities per municipality, then the largest number of business entities in 2015 was in Podgorica – 36 per cent of the total number, followed by Budva

and Bar, while Gusinje and Petnjica were municipalities with the least number of business entities in that year.

The following graph will provide an overview of business entities by size.

Graph 1: The Structure of Business Entities by Size



Source: MONSTAT, Analysis of Number and Structure of Business Entities in Montenegro in 2015, March 2016

Of total number of business entities in the second quarter of 2012, 61.6 per cent were “single member private limited companies” that if added to “limited liability companies” (21.6 per cent of the total number of business entities) made up 83.2 per cent of the total number of business entities. In regards to the type of ownership, there were 23,625 enterprises in 100% private ownership which is 99.3 per cent of the total number of enterprises. The share of this type of ownership and organisation points to the need for boosting the entrepreneurial climate in our country. As revealed by MONSTAT data published in early 2016, in 2014 and 2015 the number of enterprises in Montenegro increased – at the end of 2015 there were almost 26 thousand enterprises which is around 10 per cent higher than in 2012. Such growth over the last two years tells us that the business climate in Montenegro has improved. On the other hand, we have an obvious fact of a large number of companies that have been shut down and blocked over the last few years which is compensated with new-founded enterprises that have inherited and continued their business.

1.3 Access to FR – Possibilities (Supply Side)

In Montenegro, entrepreneurs have a few possibilities when it comes to finding financial resources they need. Financial resources are classified into two groups: commercial and non-commercial. Non-commercial group can be divided into domestic and foreign sources. Merging

these two classification approaches, one can say that an entrepreneur in Montenegro may ask the financial support from:

- Banking sector: commercial banks and micro-credit financial institutions,
- Investment-Development Fund of Montenegro (IDF),
- European Bank for Reconstruction and Development (EBRD),
- Other sources (international support programmes).

Banking sector

- *Commercial banks*

Following the transformation of the banking sector and its later privatisation as well as new investments, there are 14 commercial banks and 6 micro-credit financial institutions (MFI) in Montenegro today. Every bank of systemic importance in Montenegro has a dominant share of foreign capital which is the reason why loan approval procedures in those banks are slower (one of employers' remarks). One more bank (with dominant foreign capital) is expected to obtain a work permit in 2016. All banks and MFIs undergo supervision by the Central Bank of Montenegro (CBM). The CBM regulates the work of banks and MFIs and is established by the Law on Central Bank of Montenegro (*Official Gazette of the Republic of Montenegro* no. 52/00 and 47/01). According to the new Law on Central Bank (*Official Gazette of Montenegro*, no. 40/10 and 46/10), the Central Bank mission is to encourage and preserve stability of the financial system i.e. to stimulate and sustain healthy banking system and ensure secure and efficient payment system. Shifts in basic aggregates of banking assets over the last few years have been caused by bad situation of the real sector and the need for new sources of income that bring lower risk. Despite large amounts of newly approved loans, the overall amount of loans decreased and the increase of banking assets was based on the substantial increase of money sources position and accounts with central banks, as well as on the significant increase of investments and securities.

In 2014, the quality of banks credit portfolio recorded a slight progress but it has still been very high representing a key risk in the banking system. Moreover, the illiquidity of Montenegrin economy has still been extremely high which probably mean that banks will continue with their cautious lending policy in the coming period.

Total assets and liabilities of banks amounted to 3461.6 million EUR at the end of February 2016, which was 0.3 per cent higher compared to the previous month.

In terms of the structure of aggregate balance sheet of banks, total loans of banks make up the dominant share. At the end of February 2016, total loans amounted to 2,375.1 million EUR, which is 0.2 per cent lower compared to the previous month while they were only insignificantly lower compared to February 2015.

In terms of the structure of liabilities, deposits make up the dominant share of 75.6 per cent. In February 2016, deposits in banks amounted to 2,615.7 million EUR, which represents a monthly increase of 0.3 per cent and an increase of 14 per cent compared to February 2015. Out of the total amount of deposits in banks, corporate deposits accounted for 779.7 million EUR or 29.8

per cent, while household deposits accounted for 1,443.6 billion EUR or 55.2 per cent of total deposits.

At the end of February 2016, total capital of banks amounted to 469.2 million EUR, which is 0.03 per cent higher compared to the previous month and an increase of 4.7 per cent compared to the corresponding period of the previous year.

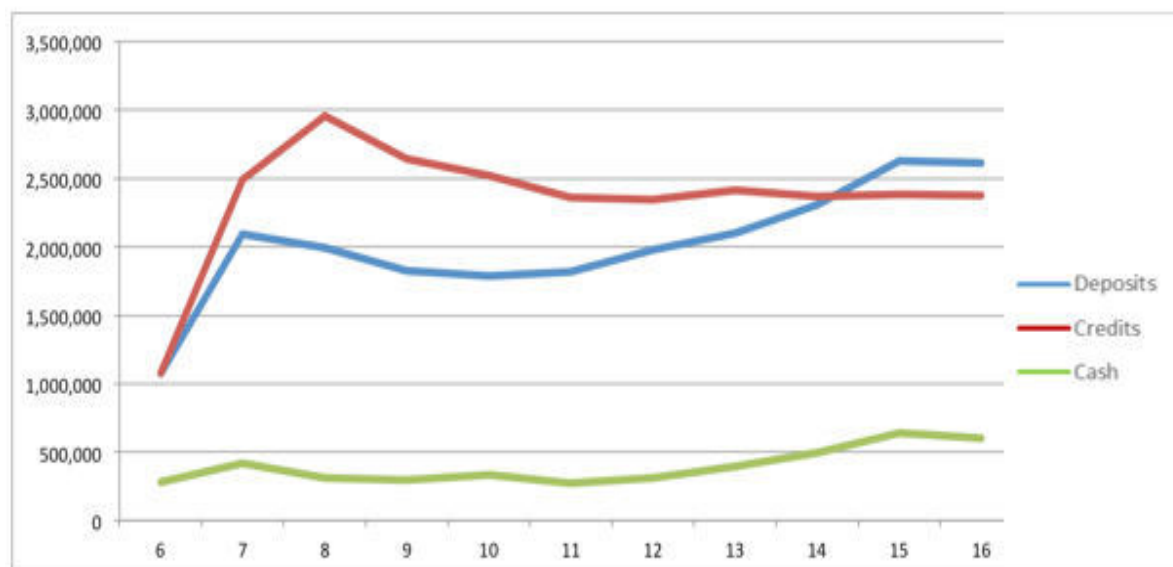
In February, past due loans (without interests, and prepayments and accruals) amounted to 349.2 million EUR, which is a decrease of 11.5 per cent compared to the previous month, while they recorded a decrease of 23.8 per cent in comparison to February 2015.

Central Bank data confirm that economy has remained a major source of credit risk. At the end of 2014, the share of corporate gross non-performing loans has still been very high compared to household non-performing loans – 29.2 per cent versus 14.2 per cent. The data for 2015 have not been available yet by this trend will not be significantly changed.

Higher level of corporate non-performing loans in comparison to households' is expected since the household sector is systemically more disciplined owing to different type of securing the loan. Moreover, the most of loan users within this sector are pensioners, civil servants and employees of well-situated companies who receive regular monthly wages.

The overall loans in Montenegrin banking system on March 1st 2016 amounts to 2.38 billion EUR in comparison to 2.62 million EUR of deposits. Until the beginning of 2015 loans were higher than deposits, however, in early 2015 deposits were equal to loans in aggregate balance sheet of banks. As 2015 went by, deposits increased – up until the beginning of 2016 when the difference between deposits and loans were as much as 240 million EUR in favour of deposits (Monetary Statistics of Depository Institutions January-February, 2016, CBM). This general indicator says enough about the substantial decline in banks readiness to lend to both companies and households.

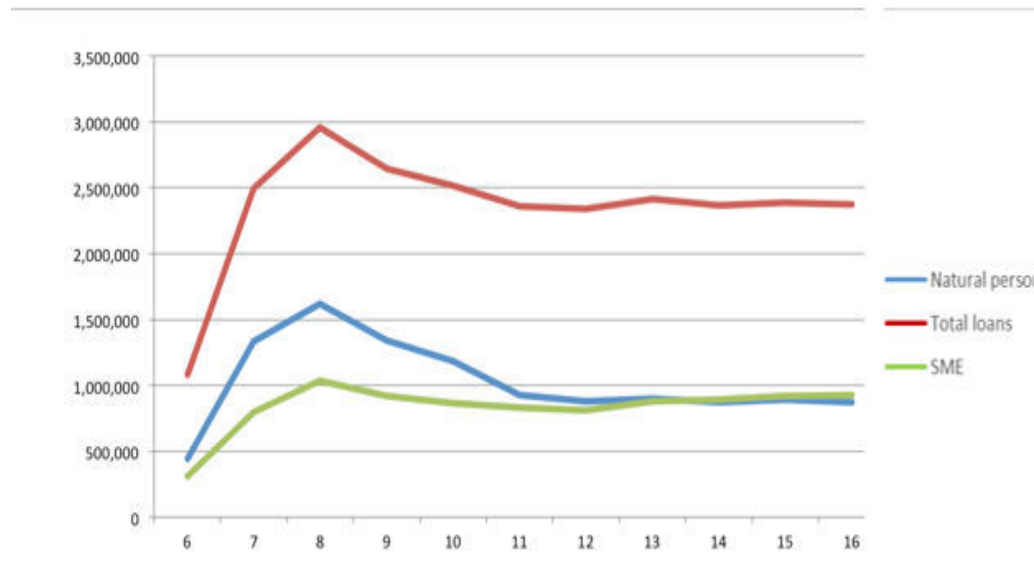
Graph 2: Shifts in Three Basic Monetary Indicators from 2006 to February 2016



Source: Central Bank of Montenegro

Graph 2 shows shifts in three basic monetary indicators in the period from 2006 to February 2016. The decline of the overall loans is continuous while deposits and cash money has a growing tendency. So, despite the growing loans potential of banks, the amount of loans has been dropping since 2008, which suggests that the access to FR has got more difficult.

Graph 3: The Ratio of the Overall, Corporate and Household Loans



Source: Central Bank of Montenegro

Graph 3 illustrates the ratio of the overall, corporate and household loans. The share of SMEs loans in the overall loans provided by the banking system on March 1st 2016 amounted to 874 million EUR i.e. 36.8 per cent of the overall loans. By comparison, on December 31st 2008, that share was 54.8 per cent (1.62 billion EUR of 2.96 billion EUR of overall loans amount). The severe decline in the share of corporate loans is obvious – it went down by 46 per cent in three-years-time (2008-2011) – from 1.62 billion EUR to 878 million EUR, while a slight fall from 878 million EUR to 873 million EUR was recorded in five-years-time (2011-2016). Having in mind that household loans dropped from 1 billion EUR in 2008 to 809 million EUR in 2012 while from 2012 to 2016 they increased from 809 million EUR to 926 million EUR, it can be concluded that banks partially compensate the decline of corporate loans with increased number of household loans.

From all the above said, it can be concluded that there are two unfavourable trends that actually impede easier access to FR. The first is the declining tendency of banks to finance companies, while the second is slower decline of interest rates than expected by companies and contrary to trends existing in broader region. It is therefore first and foremost necessary to analyse the causes of the first trend being that the second one is a reaction to lower number of approved loans (supply) whereby banks tend to compensate loans reduction with higher interest rates.

- *Micro-credit financial institutions*

The total assets of micro-credit financial institutions (MFI) at the end of 2014 amounted to 38.3 million EUR and as such do not represent a significant financing source for SMEs. Net loans and

receivables had a dominant share in the structure of MFI assets (90.7 per cent). From the sectorial perspective, almost all gross loans and receivables of MFIs related to natural persons while, in terms of their purpose, gross loans for fixed assets purchase had a dominant share in the structure of MFIs credit portfolios (with 19.6 per cent), followed by consumer loans (14.6 per cent), and cash non-earmarked loans (11 per cent). With regard to the maturity structure of MFIs gross loans, long-term loans accounted for the main share (72.8%).

- *Investment-Development Fund of Montenegro (IDF)*

As an heir of Development Fund that was founded in the process of transformation of public property, an important actor at today's financial market of Montenegro is an Investment-Development Fund (IDF). IDF was founded according to Law (Official Gazette of Montenegro no. 88/09 from January 31st 2009) with an aim to stimulate and speed up the economic development. IDF, former Development Fund, had prominent role in the process of transition and support to SME sector.

In order to intensify the activities aimed at stimulation of entrepreneurship, that would create new jobs, IDF opened a new credit line in 2016 through the Programme of Lending to University Graduates that offers the most favourable lending conditions in the region. It is an interest-free credit line for unemployed persons with university degree registered with the Employment Agency of Montenegro.

Lending conditions within this support programme are far more favourable compared to the conditions at the commercial banks market. The maximum amount of loan can reach 50,000 EUR (30,000 EUR for entrepreneurs), with zero interest rate and 12 years repayment period including 4 years grace period.

The objective of this programme is to pay specific attention to this target group in order to ensure their greater entrepreneurial engagement along with better conditions for their employment.

"Looking back at the work done in 2015, by financing projects worth 117.2 million EUR in total, IDF opened 1,889 new and kept 2,766 existing jobs. The achieved results speak in favour of the fact that IDF as an institution has seriously approached the goals set, always keeping a competitive advantage over other financial institutions in the country", said IDF representatives in the press release on February 1st 2016.

IDF presented their business results for 2015 and announce thereby their plans for the coming 2016. Considering the work done, the fact that IDF credit lines are intended for SMEs, entrepreneurs and agricultural producers and that one of its financial products is factoring (short-term financing), by financing projects worth 186.78 million EUR, IDF opened 3,629 new and kept 9,354 existing jobs from January 1st 2014 to December 24th 2015. The share of long-term loans in the total amount of loans accounted for 105.86 million EUR while the short-term loans accounted for 80.92 million EUR.³

³ *Report on implementation of the Action Plan of Employment and Human Resources Development*, Ministry of labour and Social Welfare, April 2016

Taking into account this year's structure of long-term financed projects by sectors, the greatest demand and interest of current and potential clients was in the sector of tourism and hospitality which is supported by the fact that in 2015 IDF invested 28.15 million EUR into tourism, 12.45 million EUR in manufacturing, 12.11 million EUR in services sector, 8.55 million EUR in food processing, 2.2 million EUR in agriculture and 940.000 EUR in the trade sector.

In 2015 as well, IDF approved 75 loans for projects that contributed to entrepreneurship development (to women, young people, beginners, individual agriculture producers) worth 2.67 million EUR in total. In order to boost entrepreneurship as a generator of new jobs, IDF will work on new projects in 2016 which will be aimed at ensuring as favourable lending conditions as possible and broadening of product range, since the interest rate is expected to be lower by 0.5 per cent compared to 2015.⁴

Given that IDF is able to get cheaper financing sources compared to most of commercial banks, the importance of IDF in providing support to SMEs is expected to grow.

"Our priority in this year as well (2016) will be to support entrepreneurship development especially among youth, women and business start-ups. We will continue to support the priority sectors such as agriculture, tourism, wood processing, manufacturing and services", said IDF Director, Zoran Vukcevic.⁵ He reminded that upon the Ministry of Tourism proposal, new credit lines were launched that would additionally improve tourism infrastructure and construction of new hotels. For that purpose, 80 million EUR worth loans are planned for 2016. According to IDF Director, the interest rate will drop from 4 per cent to 3.2 and 3.4 per cent. Expected grace period for SMEs is 4 years, while the projects related to environmental protection, energy and infrastructure will get up to 5 years, with 15 years of repayment period.

In 2015, directly or through commercial banks, IDF provided financial support to 307 projects in the total amount of 71.2 million EUR. If observed by sectors, the agriculture and food production sector got dominant support of 29.1 per cent, 20.53 per cent of sources was invested into tourism and hospitality sector, while 21.39 and 16.3 per cent of the amount was invested into the sectors of services and manufacturing respectively. 9.5 per cent of the total amount was invested into the sector of trade which was supported only in the north of the country. Observed by regions, the most of funds were provided in central and northern part of the country (72.8 per cent) while 27.2 per cent of financial sources were invested in the southern region. As stated at the presentation of IDF financial support programme, this year the support is projected at 21 credit line that would provide opportunities to micro, small and medium enterprises, agriculture producers and entrepreneurs to develop their existing, start new investment cycles or open new businesses.

IDF entrepreneurship development credit lines are intended to encourage further growth and development of businesses that have only just started their operations as well as of business start-ups. When it comes to improving company's liquidity, IDF offer three credit lines that can

⁴ Investment-Development Fund of Montenegro, <http://www.irfcg.me/me/component/content/article/127-saopstenje-za-medije/370-irf-rezultati-poslovanja-za-2015-g-2>

⁵ Web-portal *Analitika*, www.portalanalitika.me, March 16, 2015

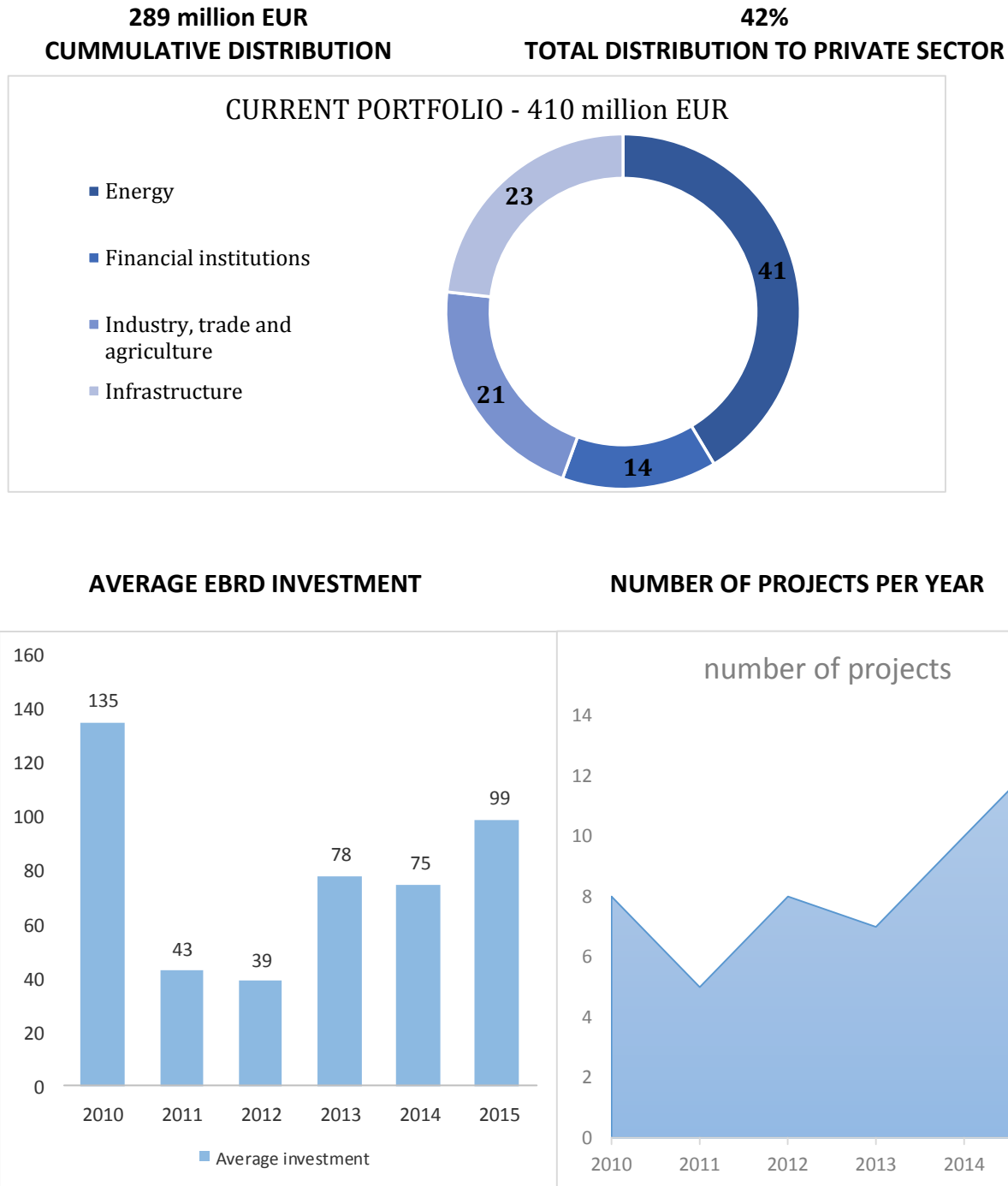
help companies deal with the problem: refinancing, fixed working capital financing, factoring financing and short-term loans.

As said by IDF then, special attention would be given to companies that regularly pay taxes and contributions. It should be an additional stimulus for those companies to create new jobs. Since this year a special credit line intended for cluster production has been available as well.

The trend of increased direct funding of SMEs is obvious lately, although IDF used to lend with guaranties provided by commercial banks which essentially made such loans by IDF non-risky. IDF is not under the CBM supervision, so the IDF risky profile will be valued by the founders. Unfortunately, we haven't been able to analytically approach IDF activities, since we haven't managed to get original data on the structure of loans given directly and through banks using bank guarantees. Loans given through banking sector are less favourable for client since the IDF interest rate (3 – 3.5 per cent) increases for 3 percentage points of the bank, and if to that we add loan application fee then the effective interest rate reaches 6.5 to 7 per cent – which is certainly more favourable than commercial banks interest rates but still less favourable than interest rate offered directly by IDF (2.5 to 3 per cent). Furthermore, unlike IDF, banks are usually not willing to approve longer grace periods. By lending through banking sector, IDF is 100 per cent protected from risk which calls into question the essence of IDF existence, given that it is not a depository institution nor is it under supervision by the CBM. In order for IDF to have a more useful role, it needs to provide more direct loans in the future. It would require strengthening human capacities within the risk department and might result in IDF increased operating costs.

- *European Bank for Reconstruction and Development (EBRD)*

With 532 million EUR of cumulative investment – through loans and owners' equities (until October 2015), European Bank for Reconstruction and Development (EBRD) is a significant actor on the Montenegrin financial market. Their selective and strict approach to SME lending so far tell they are a significant source but not to the extent that would make them crucially important for SME development. Less than a half is invested into private sector (42 per cent) while in terms of sectors; energy sector benefitted the most from EBRD investment (41 per cent).

Graph 4: EBRD in Montenegro

EBRD role therefore is definite, although SME sector cannot compete to other loan applicants since EBRD strategic goal is to finance greater projects regardless their type of ownership.

- *Other sources*

In January 2007, a new financial instrument of European Commission – the Instrument for Pre-accession Support (IPA) entered into force, providing targeted and efficient support to EU accession countries, depending on their needs and level of development. In order to reach goals set by every country in the most efficient way, these financial instruments have five components: 1) support to transition and strengthening of institutional capacities, 2) regional and cross-border cooperation, 3) regional development, 4) human resources development and 5) rural development.

European Commission allocates 34 million EUR per year for Montenegro, of which 28 million EUR go to support to transition and institutional building (IPA I) while the rest of the funds is used for cross-border cooperation programmes (IPA II).

With an aim to boost SMEs competitiveness and encourage entrepreneurial development, IPA 2011 programme funded a grant scheme for the project “Establishment of the Regional Business Centre and Incubator for North-East Montenegro” that set up a Regional Business Centre for municipalities at the north of Montenegro (Berane, Rozaje, Plav, Andrijevica and Bijelo Polje) and an Incubator situated in Berane. In 2014, IPA project “Enhancing Competitiveness of Local Small and Medium Sized Enterprises in Montenegro through Cluster Development” started to be implemented. The project provided technical support to four clusters (of wine, olive, and trout production and metal processing) and prepared 2 studies: “A Study on Funding Cluster-based Initiatives in Montenegro” and “A Study on Legal Framework for Clusters in Montenegro”.

Financial resources are also available through realisation of the three projects: MIDAS (the World Bank), IPARD (European Commission and the World Bank) and ADMAS (Abu Dhabi Development Fund).

Although FR available through other sources are valuable, one can say that commercial banks, IRF and, to a certain extent – EBRD, are the dominant sources of SME support while other external sources have exclusively commercial i.e. market motif and does not represent a reliable and permanent support to entrepreneurs in the period of development and growth of their business ideas.

2. BRIEF HISTORICAL OVERVIEW OF THE PROBLEM

After the statehood restoration, investors, which generally are not fond of uncertainty, estimated that internationally recognised Montenegro is a very attractive investment destination, having primarily been led by the three groups of motifs: on-going privatisation process, attractive taxation system (low VAT rate and income tax) and a certainty of Euro-Atlantic integrations. The entering of foreign investors generated new business opportunities for Montenegrin residents through their partnering with foreign investors or investing the money gained from property selling into new ideas and businesses. Foreign direct investment (FDI) net inflow – mostly non-existing in the first half of this decade – reached 30 per cent of GDP in 2006 and 40 per cent in 2007, stimulating domestic demand and economic growth. Real GDP growth reached the record in 2007 (10.2 per cent), which is a confirmation of the earlier

claim that Montenegrin economy can fall into recession as quickly as it can reach high growth rates. In such stimulating environment, commercial banks supported the private sector activities, largely increasing corporate loans (with 12-month growth rates exceeding 180 per cent at the end of 2007). It helped financing greater imports of goods and services which led to fast increase of current account deficit, from 8.5 per cent in 2005 to 40 per cent in 2007. That is how it happened that a positive input (such as FDI) generated the increase of the greatest problem of Montenegrin economy – a trade deficit. A short-lasting boom and great expectations were followed by the world economic crisis, officially announced in September 2008, which led to investment downturn that negatively affected the quality of credit portfolio in the entire system. All banks were more or less hardly hit by the increase of non-performing loans (NPL) and the two largest banks in the system underwent a certain measures imposed by the regulator. It resulted in substantial reduction of their lending activities subsequently causing the same trend among other banks, owing to the fact that all greater banks had very similar credit portfolios and even the same debtors with more or less exposure to risk.

The drop in the general lending activity creates a problem, especially for SMEs which can hardly deal with illiquidity and challenges of growth and development without bank support. It becomes increasingly difficult to access FR which is reflected in the interest rates growth but also in the strong growth of passive interest rates since banks strived to preserve the liquidity by getting new sources. It is evidenced that in 2007 and 2008 there were deposits with maturity over a year, with double-digit interest rate. Along with other factors, it caused active interest rate to remain very high, so even the subsidiaries of large international banks which raise the money from the sources on Euro market at EURIBOR interest rate, lent the very same money at the interest rate ranging from 6 to 7 per cent. As one of the most illustrative indicators of one economy, the interest rate, thus set at very high level and became accepted almost as a constant in our economy.

The lending boom in 2006, 2007 and partially in 2008, led to an extreme illiquidity of economy that still last today. Namely, because of the extreme trade deficit of Montenegrin economy, the majority of approved loans went out of the country by the means of international supply channels. Since the investments that caused the deficit were never finally realised, the economy was becoming less and less liquid which logically led to deterioration of credit portfolio quality i.e. to the increase of non-performing loans (NPL). In the years of the major lending expansion, the share of NPL in the total number of loans was merely 2.86 per cent in 2006 and 3.16 per cent in 2007. The next three years (2008, 2009, 2010), the share increased to 7.20, 13.50 and 20.90 per cent respectively. Such NPL growth threatened to jeopardise the stability of the banking system but in 2011 by imposing a set of measures the Central bank of Montenegro managed to eliminate the risk from illiquidity and insolvency. Along with a few more factors, it resulted in negative profitability of the banking system. In 2010 the banking system made a loss of 81.7 million EUR. With the entry into force of a new Decision on Minimum Standards for Credit Risk Management in Banks along with a new Decision on Chart of Accounts for Banks on January 1st 2013, an International Accounting Standard 39 (IAS 39) started to apply which made it more or less difficult to compare data from before and after 2013. Nevertheless, a slight drop of non-quality loans is evident. At the end of 2013, the share of NPL in total loans was 18.38 per cent reaching 16.78 per cent in 2014. The banking sector achieved a positive financial result in 2013 that accounted for a slightly more than 2 million

EUR. Credit risk remained the most obvious and the most dangerous risk in the banking sector and according to the CBM the prolongation of extremely cautious lending policy is practically inevitable.

According to employers, difficult access to FR is reflected in inadequate level and quality of the three elements of bank loans: *interest rate level, collateral value and banks' conservative attitude when it comes to grace periods approval.*

According to employers, **interest rates** are inappropriately high. High interest rates hamper profit making and capital accumulation, thus threatening to business. They think that lower interest rates would be more effective for the society as a whole because it would stimulate new initiatives.

Collateral value of the assets far exceeds the amount of the given loan which, according to employers, is a great difficulty in satisfying the lending conditions. The additional problem is banks' unwillingness to continually remove the lien on parts of the mortgage property if the value of the mortgage has increased over time. For example, if an object is eventually built on the land, it will significantly increase the value of the initial collateral but banks are still not ready to remove the lien on detailed parts of the deed. It captures the company's property i.e. slows down the turnover ratio causing unnecessary costs.

Grace period is necessary for small enterprises being that they are not capable of making immediate loan repayments, for justified reasons. Banks are reluctant to enter into arrangements which require a grace period longer than 6 months. Even then, usually an interest rate is paid, which essentially is not a relief since interest rates are high at the beginning of amortisation being that they are calculated using a reducing balance method.

3. MANIFESTATION OF DIFFICULT ACCESS TO FINANCIAL RESOURCES

Difficult access to FR is a problem most often manifested as inadequate support by banks and funds to entrepreneurial initiatives as well as insufficient state support to entrepreneurship i.e. its own development potential. Commercial banks operate in line with market principles which mean they run an expert and a very rigid risk assessment when approving the loan. Insufficient bank support to business is a consequence of different expectations of banks, on one, and businesses on the other side.

The fact that the objective of the bank is to make profit leads to a logical conclusion that every bank would like to have as large and as good interest-bearing credit portfolio as possible. Banks are therefore not expected to lend money to everyone that needs it. If the bank estimates that the loan is risky, it would rather keep the money than entering into potential losses resulting from bad loans, since once the accounting and legal procedures are over it would reduce the bank capital. It represents a huge risk for the bank since the regulator (the CBM) conducts a very meticulous analysis of the bank capital position and as soon as they feel the risk from insolvency they react by requesting recapitalisation.

On the other hand, an entrepreneur asks the support for his business idea, that he/she cannot cover from his/her own accumulation. By requesting a loan, the entrepreneur pledges his/her own or someone else's property as collateral for the loan. The practice in Montenegro is that the value of the property, by rule, has to be substantially larger than the loan, which makes it difficult for entrepreneurs to manoeuvre finding the fast solution for a short-term and/or long-term support to their business ideas. Moreover, the entrepreneur always wants lower interest rates than those offered by the bank and a longer grace period so that he/she would have time to develop a business up to the stage when the economy of scale would enable easier loan repayment.

Logically, both an entrepreneur and a bank have their own and opposed interests. Naturally, this relationship is much more complex in real life since banks do not make a living only from interest rates but from other income as well; nevertheless, in order to create a clearer picture of the essence of problem we use the method of simplification.

Still, if the gap between banks and businesses gets deeper in terms of having the banks' lending activities decline to the point when banks suffer loss, which is a phenomenon noticed in certain smaller banks with further tendency to decrease, then the banks will become victims of their own policy. It is when a state faces a major problem, since the potential breakdown of any bank in the system would have negative effects on the entire system having in mind a low diversity of the overall economic system.

An important actor in the economic life of every country is the state itself. The state participates at the market, directly as a buyer or a seller and indirectly as a regulator and a legislator. Since both borrowers (businesses) and lenders (banks) are essentially entrepreneurs it is logical that both parties, each from their own interest perspective, put pressure on the state in regards to more enabling regulations. The state is the actor which has to observe (statistics), evaluate (analytics) and regulate (legislation) economic life with an aim to optimise its overall resources.

The issue of access to FR is evident from the very fact that Montenegrin employers i.e. entrepreneurs see it as a constraint to realisation of their ideas. It has been present more or less from the moment Montenegro introduced euro as currency within internal payment system which was logical since the money stock i.e. money supply could be increased only from real sources (exports, borrowing, foreign investment, remittances, foreign donations...) while the demand for money was a consequence of many inherited structural and economic disproportions (high expenditure, high unemployment, price disparities, earlier borrowing, investment needs...) as well as of the need for further growth.

3.1 Difficult Access to FR – Bank Aspect

As all other creditors, banks have a widely known cautious approach to lending. Risk departments in Montenegrin banks are designed in a way to assess all types of risk so the final score of a borrower is a result of a very complex estimates, evaluations and measurements.

Creditors are not willing to finance SMEs if they evaluate legal and regulatory framework as uncertain which is reflected in limited reliable data on potential borrowers (no-existence of credit bureaus and rating agencies) and weak legal protection (problematic seizure of collateral, inefficient bankruptcy procedure, inadequate property rights protection). In many developing countries, a large number of SMEs operate informally. Unwillingness of financial institutions to provide resources for SMEs, stricter legislation and higher taxation rates all have negative effects on transition from informal to formal economy.

Having analysed risk departments operations in a few banks we made the conclusion that the reasons for more cautious lending are the following:

- A rigid regulatory framework set by the Central Bank of Montenegro (CBM) as a result of compliance with international banking standards,
- Bad credit history (irresponsible use of earlier loans),
- Unreliable financial statements of a company,
- Slow procedures of legal protection of the creditor i.e. the bank,
- Considerable illiquidity of economy (cash flow projection).
- Strong collateralisation of loans.

A rigid regulatory framework is the result of constitutional position of the CBM in charge of preserving financial stability. It is reflected in acceptance of all international standards of risk management in banks along with all international accounting standards (IAS) that had not been in use in Montenegro until recently. Strict application of criteria deriving from the set of decisions on minimum standards of risk management in banks, as showed by the banking practice, made it extremely difficult to classify any kind of business loan into “A” group with zero loan loss provision. The transition from worse to better classification group is very slow and takes at least 6 months which discourages banks to approve new loans to the same clients.

Bad credit history of companies is a phenomenon caused by numerous reasons. Credit history evidence is kept in the Credit Registry of the CBM, which is the only of its kind in Montenegro. Along with objective problems arising from non-compliance with loan agreement, which is a realistic reason of the bad credit history, it happens that owing to certain bureaucracy inconsistencies in client-bank-CBM Credit Registry relation, a client suffers negative consequences. Tardiness appears with all actors of this process. Irresponsible use of loans is an important factor of bad credit history. It resulted from the lack of legal pressure on cases that had happened decades ago, which eventually influenced the formation of collective awareness that it is normal and acceptable to spend resources irresponsibly i.e. for buying consumer goods and services (cars, summer holidays, clothes, various family requirements...). Every registration of irresponsible use of loan by the bank officer becomes an obstacle for getting a new loan at later stage.

Unreliable financial statements of companies are the consequence of decades’ long inertness and a lack of awareness about objective financial statements as the necessity for the object of reporting in the first place. Inclinations towards fabrication of financial statements with an aim to avoid the payment of income tax or for some other reason, have created a firm notion even among younger entrepreneurs about financial statements as pure formality one needs to

satisfy, and not a realistic need of entrepreneurs themselves and their businesses. This is the reason why risk departments within banks have disagreements with borrowers – financial statements they submit do not demonstrate satisfactory cash flows to consider the client creditworthiness despite client's claims that he/she is financially capable of repaying the loan. It should also be highlighted that small companies have unrevised financial statements which makes them additionally unreliable.

Slow procedures of legal protection of the creditor i.e. the bank cause banks to avoid taking real estates as mortgage or fiduciary unless they are high-quality real estates that are easily saleable. Even in such cases there is a fear since the acquisition of mortgage property takes 4 to 5 years on average, so the mortgage serves more as a psychological pressure than it really secure the receivables. The regulatory framework set by the CBM also requires from the bank to have a strict attitude towards debtor since depending on other elements of creditworthiness estimates the bank can demand unrealistically high mortgage - even a few times higher than the value of the receivable, which is contrary to the Law on Obligations and Contracts prescribing that only the goods of the same or similar value can be exchanged. According to employers, such bank behaviour is a significant barrier to business. The banking practice has revealed severe cases of unrealistically high mortgages regardless the fact of the loan been partially repaid and therefore much lesser than its initial value. During the analysis of this problem we found a case where for the receivables worth ca. 2 million EUR the bank seized the debtor property worth ca. 10 million EUR. These are indeed the anomalies that can be regarded as obstacles to doing business. Although it sounds illogical, with better creditor/bank protection these alternative methods of pressure on debtors would disappear. Asked by the journalist what the Central Bank and the state can do to reduce interest rates in Montenegro, Robert Kleindienst, an Executive Director of NLB Bank said: "I think that the state can do more than the Central Bank. I have already listed the key challenges and they related to systemic protection of creditors...although I primarily speak from the bank's i.e. creditor's point of view, I am pointing out that raising the systemic protection of creditors would bring benefits for the state, clients and banks altogether. Lower interest rates increase the interest for loans; widen the range of profitable investments from clients' perspective, increase clients' capabilities to duly repay the loan and reduces the risk of irregular loan repayment owing to a burden felt by the client with respect to loan repayment. Greater lending activity, providing that healthy clients and projects are financed, ultimately means greater economic growth and better life."

The issue of illiquidity of economy is explained earlier. As systemic phenomenon illiquidity is the result of systemic disease of Montenegrin economy caused by a long-term trade deficit which can be substituted only with aggressive attraction of FDI. Illiquidity affects client's creditworthiness gradually increasing the number of delayed payments days. This problem cannot be solved in the short run.

Strong collateralisation of loans is the outcome of more factors: lack of fast and efficient legal protection of the creditor, legal pressure by the regulator (the CBM), banks wish to have as low lending risk as possible along with imposing additional responsibilities on the client. This can be solved by better protection of the creditor and by modifying the CBM criteria. It is another problem employers recognised as crucial in requesting FR from banks. The collateralisation issue is manifested in another way and as such faced by most of SMEs. Namely, banks are

reluctant to remove the lien on parts of collateral if due to investment in the initial collateral, the value of collateral increases (the land turned into residential or commercial area). Banks are very conservative in this regard.

As the most prolific source of the money employers need, banks are obviously not responsive to employer needs and such tendency will continue in the coming years since in the short run it is impossible to deal with the outcomes of causal relationship between: trade deficit, illiquidity and high interest rates as well as systemic (in)consistencies in reporting, very rigid regulatory framework and (in)efficient administration.

4. INTERNATIONAL COMPARISON

Numerous analysis and reports documented proofs that SME sector face more difficulties in accessing FR than large companies, mostly because of high collaterals and insufficiently clear and predictable solvency (Ayadi and Gadi, 2013). Moreover, around 50 per cent of SMEs live less than 5 years which makes them unable to develop and quality credit history nor good relations with banks (Schrör, 2009). SME financing is monitored by OECD which in its annual reports makes detailed analyses of all aspects of this process. Montenegro is not covered by those reports so it is impossible to determine its comparative position only on the basis of this very detailed and comprehensive document. The last available is the OECD report for 2015 containing the data for 2013 - Financing SMEs and Entrepreneurs 2015: An OECD Scoreboard.

The report contains data on 34 countries (Austria, Belgium, Canada, Chile, China, Columbia, Check Republic, Denmark, Estonia, Finland, France, Greece, Hungary, Ireland, Israel, Italy, Japan, Korea, Mexico, the Netherlands, New Zealand, Norway, Portugal, Russia, Serbia, Slovakia, Slovenia, Spain, Sweden, Switzerland, Thailand, Turkey, Great Britain and USA).

Lending conditions analysed by this report are: financing costs (interest rate), collateralisation and refused loans rate. Some of the key recommendations point to substantial differences between countries but also to similar features of access to FR shared by countries of similar economic characteristics.

SME's access to FR continues to be difficult because of the economic downturn and the need for preserving the banks' capital. Economic recovery is imbalanced resulting in differing indicators. The current indebtedness has reduced along with the number of newly approved loans.

Although lending conditions in some countries has been relieved, a general impression is that the SME sector still has to deal with very rigid lending conditions. Once severe problem, collateralisation is now a moderate issue for SMEs; interest rates are being reduced along with the share of refused loans (so called rejection rate is not available for many countries since it lacks the adequate data source). Nevertheless, lending conditions are still rigid especially in the countries that were hardly hit by the global economic crisis.

There are some implications about the drop of demand for loans. Even when the lending conditions are favourable, the demand for loans has not increased since matching demand and

supply requires certain time. Another possibility is that a small number of SMEs happened to experience an easy access to FR, while the majority of them still face, even greater, difficulties in that regard.

Loan repayment delays are decreasing, and the number of SMEs that went bankrupt remained at the last year (2012) level. Generally speaking, enterprises have improved their score when it comes to cash flow.

Non-performing loans (NPL) represent a recovery risk for some European countries. High level of NPL is a threat to the overall quality of bank resources exposing them to loss. The fear of loss forces banks to reduce their lending openness which can ultimately result in the new banking crisis. OECD estimates imply that the access to FR will remain difficult for quite some time, at least until the recovery gets consolidated and global political issues resolved.

It can therefore be stated that wider neighbourhood, as well as the most developed countries, encounter similar reasons of difficult access to FR. Banks have remained the most important source of financing, just like in Montenegro. However, structural differences between Montenegro's and other countries' economies prevent us from applying the conclusions of this analysis to each individual country. Unlike SMEs in developed and middle developed countries, SMEs in Montenegro do not have the possibility of using the alternative sources of finance. Although it is the issue Montenegro should work upon, serious effects of such financing will be visible only after Montenegro joins EU.

5. IMPACT OF MACROECONOMIC AGGREGATES TO AVAILABILITY OF FINANCIAL RESOURCES

For the purpose of this report, we will examine in more detail a few indicators of macroeconomic aggregates that have a strong impact on the access to financial resources.

Business environment

It is evident that according to estimates made by European officials and available statistical data, Montenegro demonstrates positive shifts towards higher level of administrative structure, more quality public service and improvement of legislative structure for the sake of creating enabling business environment. Negotiations with EU have been taking place according to planned dynamics and, in 2015 Montenegro was invited to join NATO. Legal and political environment, with all the problems and difficulties, shows the tendency of cyclical positive changes.

At the end of 2014, Montenegro was awarded with B+ (B plus) long-term foreign currency credit rating by the rating agency Standard and Poor's (S&P). Such rating has remained since November 2014, after it had increased from BB- to B+ and the outlook had been changed from negative to stable. The rating BB+/stable awarded in March 2007 was the best rating of Montenegro ever since S&P started to rate Montenegro (i.e. since December 2004). Compared to other countries from the region, Montenegro is among the countries with worse rating, but outperforms Albania, Bosnia and Herzegovina and Greece that were rated B. However, other

countries from the region are not significantly better than Montenegro. Only Slovenia and Romania has the investment rating (A- and BBB-) while Bulgaria, Croatia and EU member states are rated BB+ and BB, respectively.

Table 2: Credit rating

Country	Rating	Date	Outlook	Date
Slovenia	A-	12/02/2013	Stable	12/02/2013
Romania	BBB-	16/05/2014	Stable	16/05/2014
Bulgaria	BB+	12/12/2014	Stable	12/12/2014
Croatia	BB	24/01/2014	Stable	24/01/2014
FYR Macedonia	BB-	24/05/2013	Stable	24/05/2013
Serbia	BB-	07/08/2012	Negative	07/08/2012
Montenegro	B+	14/11/2014	Stable	14/11/2014
Albania	B	06/12/2013	Positive	10/10/2014
Bosnia and Herzegovina	B	28/03/2012	Stable	28/03/2012
Greece	B	12/09/2014	Stable	18/12/2012

Source: Bloomberg

This data is necessary for comprehensive overview of the issue of difficult access to FR since it is a basis for defining a so called “country risk” – the necessary element for determining the price of the money i.e. interest rates values.

Gross domestic product - GDP

Montenegro's GDP growth rates have been substantially positive over the last 5 to 6 years (ranging from 2 to 3.5 per cent). Only in 2012 there was a negative trend. GDP in 2015 amounted to 3.595 million EUR (Quarterly Gross Domestic Product of Montenegro 4th quarter 2015, MONSTAT). According to preliminary MONSTAT data, based on quarterly estimates, the annual GDP growth of Montenegro in 2015 is 3.2 per cent. The growth in each quarter of 2015 compared to the same periods in 2014 was 3.0, 3.7, 4.2 and 1.4 per cent respectively, which is lower than projections by the Ministry of Finance and the Central Bank ranging between 4 and 4.3 per cent. Hence, GDP growth rate corresponds to economic shifts in the region and wider proving that, depending on exogenous factors, Montenegrin economy can achieve high growth rates. Moreover, Montenegrin economy proved very sensitive to a few external variables shifts,

primarily foreign direct investment inflow. FDI inflow has relatively rapid impact on BDP change in both directions.

Labour Market – Unemployment – Pension and Disability Insurance Fund

According to MONSTAT data for 2015, Montenegro had 221 thousand of employed, and unemployment rate at 17.6 per cent.

Table 3: Workforce and activity rates in Montenegro in 2015

	<i>Montenegro</i>	<i>Coastal region</i>	<i>Central region Total</i>	<i>of which Podgorica</i>	<i>Northern region</i>
in thousands					
Total population	619.3	148.6	292.8	185.2	177.8
Active population	268.9	66.7	134.1	93.3	68.1
Active population – men	146.8	36.8	70.8	48.2	39.2
Active population – women	122.1	29.9	63.3	45.1	28.9
in thousands					
Employed	221.7	61.5	117.5	82.7	42.7
Employed men	120.8	33.7	62.0	42.6	25.0
Employed women	100.9	27.8	55.5	40.1	17.7
%					
Employment rate	44.3	50.3	49.8	56.1	30.0
Employment rate for men	49.4	57.3	54.2	60.2	35.1
Employment rate for women	39.4	43.8	45.6	52.3	24.9
in thousands					
Unemployed	47.2	5.2	16.6	10.6	25.4
Unemployed men	26.0	(3.0)	8.8	(5.6)	14.2
Unemployed women	21.1	2.1	7.8	5.0	11.2
%					
Unemployment rate	17.6	7.8	12.4	11.4	37.3
Unemployment rate for men	17.7	8.2	12.4	(11.6)	36.2
Unemployment rate for women	17.3	7.0	12.3	11.1	38.8

Source: MONSTAT, Labour Force Survey 2015

According to the *Governor's Report for January-February 2016*, the average number of employed persons in January 2016 was 170,434, which is 1.2 per cent less compared to the previous month and 0.4 per cent higher compared to January 2015. In February 2016, the number of unemployed persons amounted to 42,616, which represents an increase of 3.5% in comparison to the previous month and an increase of 21.2% compared to February 2016.

Substantial differences between MONSTAT and CBM data are not hard to explain. It suggests the high level of informality i.e. undeclared work. The official statistics does not register undeclared work i.e. those activities that are declared through M4 form such as various types of

services (housekeeping, babysitting, maintenance, extra classes, at-home care, resale activities, apartment rentals etc.). One should also have in mind that a part of the earning is paid in cash i.e. it is not registered in official statistics which is the reason why the average net salary is calculated a bit lower than it really is. This evaluation can hardly be quantified for the understandable reasons of discretion in the survey process.

According to data related to pension expenditures in February 2016, Pension and Disability Insurance Fund pays out 124,695 users of pension and disability insurance in total. Of that number, 115,825 beneficiaries reside in Montenegro while 8,780 are abroad.⁶ This data is valuable for easier understanding of burden on the business. Comparing the numbers of employed and pensioners, we come to the indicator that 100 pensioners are serviced by 143 employed which is a large fiscal burden on one employee ultimately resulting in 35 per cent of annual deficit of the Fund that is compensated from the state budget (D. Perovic, Director of the Fund).

Trade deficit

Analysing Montenegrin economy, a well-known Slovenian economist Joze Mencinger in September 2013 said that its greatest problem is trade deficit. Asked by the journalist of portal *Analitika* if Montenegro has really bad economic figures as considered by some economists, professor Mencinger responded: "I am not sure that your figures are so bad. In my opinion, you don't have major problems related to budget deficit; it is lesser than in many EU countries. My opinion on Montenegrin economy is based on balance of payments – where there is a greatest problem: current account deficit reached 40 per cent of GDP, while the balance of goods deficit was as high as 60 per cent of GDP. Simply saying, it means that you spent 40 per cent more than you produce. It is a large deficit partially covered by foreign investments, i.e. by selling of manufacturing capacities and a country itself and partially by borrowing. What will happen when you sell all of your manufacturing capacities?"

Analysing the trade deficit we will try to determine its impact on formation of money supply in Montenegro. In 2014 imports amounted to 1.784 billion EUR, while the value of exports was only 0.332 billion EUR. The trade deficit amounted to 1.452 billion EUR. Negative impact of goods deficit is alleviated by the positive difference between services imports and exports and net amount of foreign investments.

Table 4: Countries with Greatest Turnover from External Trade in Montenegro

COUNTRIES WITH THE GREATEST TURNOVER FROM EXTERNAL TRADE IN MONTENEGRO				
IMPORT	2013		2014	
	in mil EUR	%	in mil EUR	%
TOTAL	1773.4	100	1784.2	100
Serbia	505.9	28.5	480.7	26.9
Germany	116.5	6.6	114.7	6.4
Italy	117.6	6.6	116	6.5

⁶ Web-portal *Analitika*, www.portalanalitika.me 28/3/2016

Greece	149.8	8.4	144.5	8.1
China	142.9	8.1	132.7	7.4
Bosnia and Herzegovina	126.2	7.1	126.7	7.1
Switzerland	13	0.7	12.5	0.7
Croatia	97.5	5.5	107.7	6
Slovenia	64.1	3.6	56.7	3.2
Austria	33.5	1.9	32.4	1.8
France	17.5	1	28.3	1.6
COUNTRIES WITH THE GREATEST TURNOVER FROM EXTERNAL TRADE IN MONTENEGRO				
EXPORTS	2013		2014	
	in mil EUR	%	in mil EUR	U%
TOTAL	375.6	100	333.2	100
Italy	15.7	4.2	34.8	10.2
Serbia	133.5	35.5	80	24
Greece	3.6	1	0.3	0.1
Slovenia	36	9.6	13.3	4
Bosnia and Herzegovina	18.4	4.9	31.9	9.6
Kosovo	19.2	5.1	21.4	6.4
Germany	13.3	3.5	5.9	1.8
Hungary	1.1	0.3	0.6	0.2
Albania	12	3.2	15.2	4.6
Croatia	59.5	1.9	33.1	9.9
Check Republic	4.6	1.2	3.1	0.9

Source: MONSTAT, Montenegro in Numbers 2015

5.1 Interactions of key economic problems and their impact in interest rate

Fundamental systemic weaknesses of Montenegrin economy, such as **trade deficit** and cyclic **lack of foreign direct investments** generate periodical liquidity problems for the economy.

Liquidity problems cause **financial indiscipline**, that result in lower budget revenues. Lower revenues then signal the state to put pressure on employers for non-payment of fiscal responsibilities. In such conditions it is impossible to allocate enough money for investments so the demand for financial resources, i.e. loans is permanently high. The major economic problem, despite positive GDP growth rates in recent years, is illiquidity. From the perspective of enforced tax collection indicators, the state of Montenegro's economy worsened in comparison to 2013. Thus, at the end of 2014, the blocked amount of entities with frozen accounts uninterruptedly for a period longer than one year was 437.7 million EUR (9 per cent higher), while the total amount blocked was 496.1 million EUR, recording an increase of 13.5 per cent (Financial Stability Report 2014, CBM). Out of 77,584 legal persons and entrepreneurs, at the end of February 2016, accounts of 15,014 or 19.3 per cent were frozen. The number of frozen accounts of legal persons and entrepreneurs, increased by 0.2 per cent compared to the previous month. At the end of February 2016, total amount of debt being the basis for freezing of accounts amounted to 557.2 million EUR, showing an increase of 0.6 per cent in relation to

the previous month as well as an annual increase of 8.7 per cent (Governor's Report January-February 2016, CBM). It is obvious that the liquidity of Montenegrin economy worsened over the period of 14 months, whereby the liquidity of banks, on the other side, is inarguable, and bank liquidity indicators within the system have always been high above the limits.

Owing to high demand for loans, **interest rates** maintain their relatively high levels. Low economic liquidity results in loan repayments delays, or even longer periods of complete non-compliance with loan agreements, forcing banks to acquire a very conservative attitude towards borrowers for two reasons. The first is the pressure put by regulator (the CBM) related to additional loan loss provision reservations (driving the bank into potential sub-capitalisation), while the second comes out of the bank wish to keep the revenues by reaching out to high interest rates as means to compensate the loss in the event of default loans. Clearly, the interest rate is always a consequence of distorted structural relations in the economy, and never a cause of such state. It can hinder the process like high body temperature can hinder the recovery from an illness but it can never be the cause of that illness.

The interest rate play a number of different roles in the economy: it helps by guaranteeing that the current savings will generate investments with an aim to achieve economic growth; it affects the availability of loans; it balances supply and demand for money; it is an important tool of government policy for influencing the range of savings and investments. Economic literature recognises a plenty of definitions of the interest rate and its essence. What is common for all those theories is that the interest rate is the price paid by someone who needs money to the one that does not need the money and is willing to lend it for some time. Interestingly, the literature also distinguishes the interest rate which price does not include the risk factor, implying that the interest rate has to exist in completely safe loans as well, being determined by the costs of money keeping. Money keeping brings certain costs (safe deposit box, alarm, security...). The more money is kept, the greater the costs are. It is the reason why the money owner goes to the bank and deposits his/her money and authorise the bank to use that money for a certain period of time (half a year, a year, two or more), believing that investing into the bank is the least risky activity. The price paid by the bank to receive that money is actually a "risk free" interest rate (if the bank has a highly recognised rating). It is the so called passive interest rate. If that money were not given to someone else, the bank would have expenditures and its existence would not make any sense. It is the reason why the bank looks for the opportunity to lend the deposited money for the period of time approximate to the deposit time but at the higher price than the one the bank pays for that money. Bankers call this the *interest rate spread*. The difference between passive and active interest rate is the basic source of bank profit which is the reason why all banks strive to make greater interest rate spread. That difference is influenced by many factors (investment demand, country risk, individual investor risk, loan security, fixed bank costs, the level of regulatory pressure on the banks etc.).

Hence, a high interest rate spread per se suggests it is about the combination of high risk factors and real price of other bank costs. A logic conclusion is that the higher interest rate spread implies greater levels of country and credit risks along with higher values of other factors.

IMF mission, led by the Chief of Team for Montenegro, Alasdair Scott, pointed out that the costs (general and reservation) are the reason for high interest rates by the banks. Besides, the competition caps interest rates on new loans to the extent they jeopardise the survival of some minor banks with higher operating and financing costs and poorer client base.⁷

IMF warns that the pressure of costs along with reduction of interest rates on loans in order to win a couple of good clients, lead some banks to highly dangerous zones. According to IMF, there are no simple solutions for high interest rates that on the regional level are similar. More precisely, high prices of long-term financing, economy slowdown and high overall indebtedness coupled with high credit risk, low rate of non-performing loans recovery and other structural inflexibilities probably contribute to interest rates increases and greater aversion to risk, as estimated by the IMF.

External factors that have strong impact on the level of interest rate are: economic growth change, inflation, money supply, budget deficit and the balance of payments. Having in mind that inflation in Montenegro is out of the high rates zones, we can say that it does not play an important role in interest rates formation.

High interest rates are obviously the problem impossible to be solved easily since they represent the outcome of long-term problems of Montenegro's economy, a significant balance of payments deficit and economic illiquidity as an ultimate effect of all just mentioned. It is the reason why the systemic support to easier access to FR has to be built by affirmation and strengthening of cheaper FR that have to be underpinned by the state.

In January 2016, the weighted average nominal interest rate (WANIR) on total loans granted amounted to 7.65 per cent while weighted average effective interest rate (WAEIR) amounted to 8.47 per cent. WANIR and WAEIR recorded respective monthly decreases of 0.05 and 0.06 percentage points. WANIR and WAEIR recorded respective annual declines of 0.74 and 0.73 percentage points.

In January 2016, the weighted average effective interest rate on total loans granted, including all of their associated costs, recorded an additional decrease of 0.06 percentage points, amounting to 8.47 per cent (*CBM Bulletin January – February 2016*). The weighted average nominal interest rate in the same month decreased for 0.05 percentage points amounting to 7.65 per cent. In the same month, both effective and nominal interest rates on new loans recorded drops of 0.36 (amounting to 7.76 per cent) and of 0.4 percentage points (amounting to 6.94 per cent) respectively. The weighted average effective interest rate of MFIs increased for 0.01 percentage points to 24.60 per cent while the weighted average nominal interest rate declined for 0.01 percentage point to 20.84 per cent. MFI's interest rates on new loans increased: the effective interest rate increased for 1.07 percentage points amounting to 25.62 per cent while the nominal interest rate recorded an increase of 0.72 percentage points amounting to 21.31 per cent (*CBM Bulletin January – February 2016*). The weighted average effective interest rate on deposits in January 2016 was slightly lower compared to December 2015 amounting to 1.22 per cent. The weighted average effective interest rate on natural

⁷ Web-portal Bankar.me, 30/3/2016

persons' deposits in January 2016 recorded a drop of 0.01 percentage point amounting to 1.59 per cent while the weighted average effective interest rate on legal person's deposits recorded only a slight increase of 0.77 percentage points.

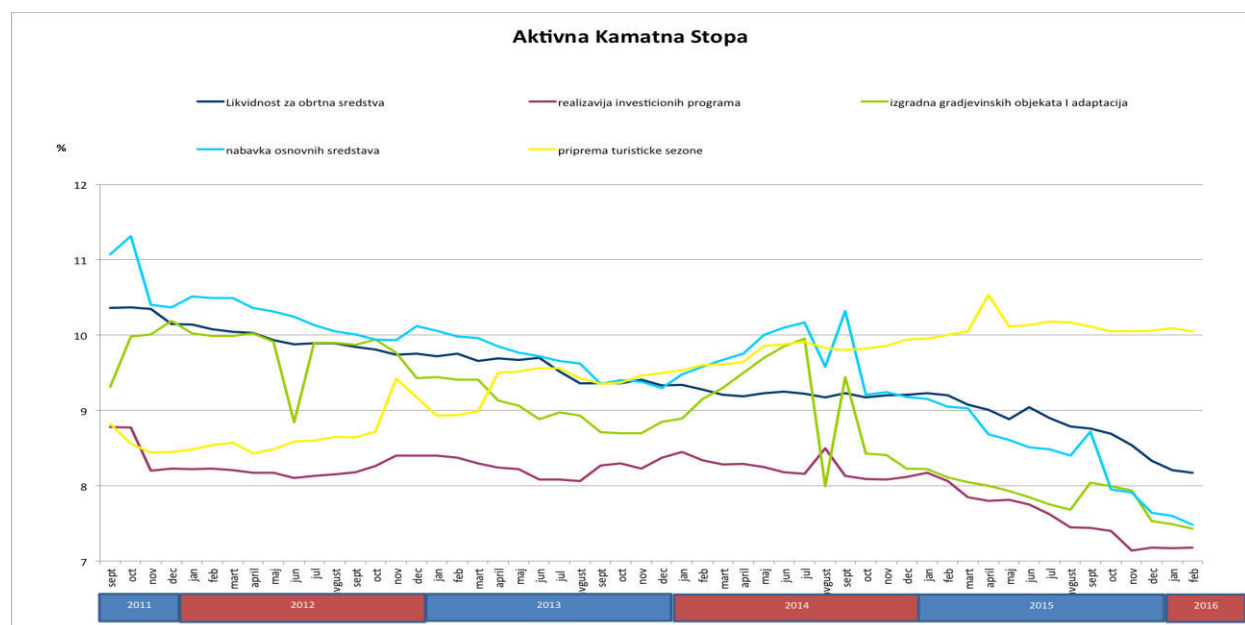
The difference between active and passive interest rates in January 2016 was 7.25 percentage points and it was lower in comparison to December 2015.

The Average Active Interest Rate in Montenegro

According to the CBM, bank operating costs influence the level of interest rate as well since they tend to grow. Thus the general bank operating costs at the end of 2015 amounted to 116.2 million EUR which is an increase of 6.61 per cent in comparison to previous year's corresponding period. That data has to be taken as precise; nevertheless, other operating costs have to be analysed as well since the supervising costs of the CBM at the level of system increased (in one of the minor banks in the system, these costs have been doubled compared to the previous year). The highest share of bank operating costs refers to wages amounting to 52.14 per cent in 2015 (55.93 and 53.52 per cent in 2014 and 2013 respectively). So, operating costs alone account for 45.95 per cent of the overall bank expenditures, followed by expenditures from interest rates with 19.02 per cent share. Finally, expenditures arising from assets (loans) impairment have a substantial share of 15.45 per cent in the total operating costs.

It is therefore clear that the interest rate is a very complex mechanism influenced by many factors but the dominant role in formation of such high money price in Montenegro is played by risks (both country and credit risks) as well as operating costs.

Graph 5: Active Interest Rate



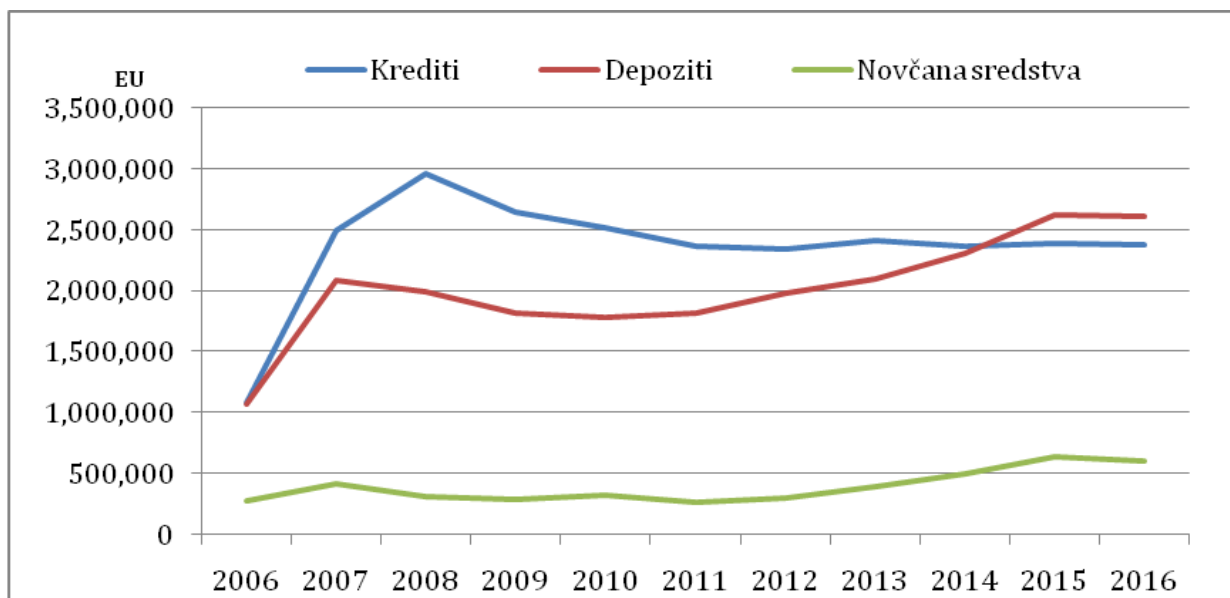
Source: Central Bank of Montenegro

The above Graph shows that the interest rate was lowest for realisation of investment projects having recorded a constant drop over the last five years. The declining tendency is recorded by interest rates for the sector of construction, fixed assets supply, liquidity and working capital. The only interest rate that has increased is the one on loans given for the purpose of tourism season preparation. Such trends imply general interest rates drop, with cyclic (seasonal) growth in the demand for tourism season preparation loans maintaining slightly higher levels of the interest rate.

Monetary aggregates

Montenegro is not in the position to run its own independent monetary policy so the problems arising from the lack of resources have to be solved in one of the following ways or by their combining: by attracting investments, by remittances, donations and borrowing (or current debt refinancing), by reducing expenditures, and by imports substitution and exports increase. For the reason of not having its own emission bank, Montenegro does not have its official reference interest rate, but it relies on market formation of both interest rates on its own securities and banking sector interest rates. A good side of this fact is that Montenegro's administration is not able to influence inflation, at least not to a great extent, along with lower transaction costs compared to countries with their own currency. A bad side is sublimated in the fact that every solution to the problem has to have realistic background/rationale, which for the small economy like Montenegro's is very hard due to its low competitiveness as synthetic indicator of all economic shortcomings.

Graph 6: Shifts in Loans, Deposits and Cash



Source: Central Bank of Montenegro

6. CONCLUSIONS AND RECOMMENDATIONS

The current situation in Montenegro with respect to access to FR has to be evaluated as unfavourable, although one has to admit a permanent progress over the last three years.

The most important conclusions:

1. Banks are not seen as support pillars to SME development due to 4 fundamental reasons: high interest rates, insufficient grace period, aggressive collateralisation and bad legal protection of the creditor.
2. The similar goes for MFIs, which face other limitations depending on their size.
3. SME profits do not guarantee that the majority of companies are able to develop using their own capital.
4. EU accession funds can help, but on the other hand, they too are not the reliable support to the enterprise in later stages of its development.
5. IDF can become a strong generator of SME growth and development provided that it maintains its direct lending, without mediation by banks.
6. High interest rate is the result of more negative economic trends, the most important of which are: high trade deficit, illiquidity and unsteady foreign investments.
7. High level of country risk is another factor that influences maintaining of relatively high interest rates.

Desirable solution would be to have banks as basic sources of missing finances. It is the effort one should persist upon, although the outcomes will not come quickly, since every administrative pressure on banks will threaten the survival of some banks risking to jeopardise whole system.

Recommendations:

1. The CBM policies should be adapted to provide higher relaxation of rules on loan loss provision.
2. Interbank market should be established as the fastest response to resolution of everyday issues of the banks.
3. A possibility of temporary use of required reserves to support the economy should be considered but only to the extent not to jeopardise the stability of the system.
4. The level of accounting culture of the society as a whole should be increased since it will become the legal obligation as we approach EU membership.
5. A possibility of synchronised state activities should be considered with respect to faster revitalisation of acquired bank assets.
6. The CBM policy should target easier refinancing of NPLs in line with project financing principles.
7. New loans should not be automatically classified into the same group if the analyses prove the sustainability of their business plans.
8. The CBM should ensure that banks release the collateral where technically possible and if the loan has been substantially reduced, so that the borrower may reallocate the

resources faster. This would prevent having the collateral 4 or 5 times higher than the exposure to risk in the amortisation.

9. The process of disputed receivables collection should be speeded up and improved by enabling the implementation of the Law on Property-Legal Relation without its collision with the Law on Enforcement and Security Procedures.

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