



INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

Facsimile Number
1-202-623-4661

June 23, 2009

Mr. Igor Luksic
Minister
Ministry of Finance
Stanka Dragojevića br. 2
81000 Podgorica
Montenegro

Dear Minister Luksic,

As agreed, I wanted to follow up on our discussions in Podgorica last week by laying out the next steps required for continuing discussions for a possible Stand-By Arrangement.

There are three immediate priorities:

First, adopt a realistic macroeconomic framework

As indicated in my presentation at the Dutch constituency meeting, all countries, including ones that are more diversified and entered the global crisis from much stronger initial conditions, are projected to contract significantly in 2009. Montenegro is no exception according to recent economic indicators. Thus, program negotiations would be greatly facilitated by adapting the macroeconomic assumptions underpinning the revised budget to these realities. As a guide post, growth of minus 4 percent in 2009 and minus 2 percent in 2010 would appear reasonable starting points at the current juncture.

Second, redress the rapid deterioration of public finances

We agreed (when we subsequently met to discuss Montenegro) that adjustment measures equivalent to around 5 percent of GDP would be acceptable, provided they were of high quality and durable. The aim would be to keep the overall borrowing requirement between 8½ and 10 percent of GDP. This limit on the borrowing requirement would include the cost of bailing out KAP, the costs of restructuring Prva and boosting banking system liquidity, and any other costs associated with debt buybacks and restitution bond redemptions, on top of the underlying fiscal deficit. The medium term objective would be to gradually eliminate the structural fiscal deficit over the next 3–4 years.

As I indicated to you during that meeting, we continue to have concerns about the handling of restitution claims or similar operations. I would like to reiterate the Fund's longstanding advice to suspend the payment of partial claims until all claims have been identified and settled (under

current trends, restitution debt could easily reach 30 percent of GDP, triple the ceiling envisaged in the Restitution Law). Moreover, the envisaged payment runs counter to the government's initial intention to transfer these claims into perpetual, interest-only bonds. Finally, and most importantly, given the difficult fiscal position over the next years, I would note that the servicing of domestic debt related to ex-Yugoslav frozen foreign currency deposits and pension obligations will necessitate further tax increases and/or expenditure cuts, unless such debt is restructured in line with the budget's ability to pay.

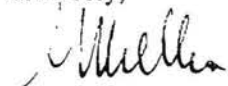
Third, proceed with the rehabilitation of Prva Banka in line with international best-practice.

As you may remember, our discussion only touched on the general principle. Upon my return to Washington, I have asked our expert staff to flesh out what this would specifically imply given *Prva Banka's* severe undercapitalization and illiquidity. Accordingly, the intervention in Prva needs to be immediate and decisive:

- i. stop further repayments of the government loan for as long as the bank remains seriously undercapitalized and illiquid;
- ii. ask shareholders to augment the bank's capital by €25 million of liquid assets by July 15, and if they fail to comply
- iii. have the government and the Central Bank take over *Prva*, to prepare it for restructuring, and install new management with impeccable reputation of integrity, extensive banking experience, and independent from the bank's current owners;
- iv. eliminate the requirement for banks to invest part of their required reserves in Treasury Bills, to urgently boost liquidity in the banking system; and
- v. submit to parliament without delay amendments to the Banking Law in line with our earlier technical assistance for adoption by the time program negotiations are concluded. The Fund has provided further explanations to the amendments in the Banking Law (attached).

On the basis of these initial actions in all three areas, it should be possible for us to quickly field a negotiation mission that would then work with you to iron out the details of the adjustment program, including the Prva's restructuring, liquidity support to banks, and fiscal adjustment. It is our hope that such a program will contain the right mix of fiscal adjustment and financing to restore confidence both at home and among international investors.

Sincerely,



Marek Belka
Director
European Department

Attachment