

The Money Market in Montenegro - Conditions, Development and Outlook

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Summary: The money market represents a segment of financial markets wherein the objects of trading are funds with short-term maturities. The money market in Montenegro is still in its early stages of development, and is characterized by a narrow scope of trading material and by a relatively narrow variety of participants. The reasons for such slow development of the Montenegrin money market are numerous: lack of regulations, dollarization as a model of monetary and foreign exchange regime, excessive liquidity of domestic banks, insufficient liquidity in the corporate sector, limited protection of creditor rights, and minimal corporate transparency. Short-term government bonds ('T-bills')-traded exclusively on the primary market--are the only short-term securities on the Montenegrin money market. Montenegrin banks are the biggest investors in T-bills. Foreign investors withdrew from the primary T-bill market after a decrease in T-bill interest rates. For a while, many considered that inadequate solutions in the Law on Securities were the main setbacks to organizing a secondary T-bill market. However, amendments to this Law did not spark the development of a T-bill market, nor any other short-term securities market. Adequate legislation is essential for the development of the money market, but it is not a sole precondition. A decrease in banks' liquidity (as competition from other financial institutions increases and/or deposit interest rates decline) is important to induce the money market's development. We can expect a concurrent decrease in lending interest rates only as the conditions of creditor rights protection and business operations transparency improve. Only under such conditions can we expect banks and other financial and non-financial legal entities to begin issuing short-term securities.

Key words: Money market, Short-term securities, T-bills, Liquidity of banks and companies, Protection of investor and creditor rights, Business transparency.

JEL: E42, E52, E58

Introduction

A money market is part of the financial market in which liquid financial assets with short-term disposability are traded. The interest rate and the issuer's credit solvency are the main price determinants of these financial assets, and are their basic sources of price volatility. Other types of risk--generally more common

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with longer terms of investment--influence prices of short-term financial assets to a minor degree.

Money market securities are promptly convertible to cash for relatively low fees and provide low risk of loss over a short time horizon. Money market instruments enable investments to generate higher rates of return compared with cash savings. However, cash is liquid *per se* and has a relatively low credit risk. Money market instruments have three main characteristics: they are usually denominated in large amounts, have short-term maturity, and have minor call risk.

Objects traded on the money market include short-term government bonds (T-bills), inter-bank loans, repurchase agreements, commercial certificates, tradable certificates of deposit, and bank guarantees. Issuers in the money market include central banks that issue currency, government institutions and agencies, companies, and financial institutions. Buyers in the money market include central banks, commercial and investment banks, money market brokers and dealers, companies, and financial institutions such as investment funds. The key participant in a money market is the central bank, holding its own short-term securities and T-bills in its portfolio. The central bank performs open market operations with this portfolio to release money into and to withdraw money from circulation.

1. The Money Market in Montenegro

The money market in Montenegro, generally speaking, is in its initial stage of development and is characterized by a restricted, or more precisely, narrow spectrum of trading material and relatively small number of participants.

There are multiple reasons for the Montenegrin money market's slow development: inadequate legislation, dollarization, excessive liquidity of domestic banks, insufficient liquidity of companies, limited protection of creditor rights, and minimal corporate transparency. Until recently, legislation lacked both appropriate laws and enabling regulations. In 2000, Montenegro adopted dollarization¹ (that is, euroization) as its monetary governance model. As a result, the Central Bank of Montenegro (CBM) could issue neither money nor short-term securities; however, the CBM is allowed to trade T-bills on the secondary market.

A lack of confidence in the domestic banking system--causing low bank liquidity--also restrained the money market's development at the beginning of the transition period (2000). Later, banking system reforms causing excessively high bank liquidity slowed the development of the money market. The period of relatively low confidence in the domestic banking system remained until--and

¹ Decision on Taking Over of Certain Mandates of NBY Aimed to Protect Economic Interests of RoM. *Official Gazette of RoM*, 41/99; and Decision of Use of German Mark as of the Payment Mean Aimed to Protect Economic Interests of RoM. *Official Gazette of RoM*, 22/00.

immediately after--the adoption of the Law on Banks and the Law on the Central Bank of Montenegro. Under such circumstances, banks could not issue short-term securities because there was not sufficient demand for them. As confidence in domestic banks recovered, their liquidity began to rise, supported by foreign capital and credit (motivated, in turn, by high interest rates on loans of Montenegrin banks). In that case, banks did not need to issue short-term securities. Domestic banks' liquidity growth earned them an active role in the money market. However, their role was on the market's demand side; banks became the most important investors in the only money market securities introduced in the meantime: T-bills.²

Additionally, domestic companies' low creditworthiness--one of the main reasons for their persistent low liquidity--slowed money market development.³ On the one hand, companies had insufficient liquidity to generate demand for existing short-term securities; on the other hand, the liquidity shortage and huge inter-company debts existed and were tolerated for years. There are three basic reasons for such circumstances: the judiciary's poor efficiency, the state's lacking initiative to perform the mutual clearance of debts,⁴ and insufficient corporate transparency due to the absence of both rating agencies and a public credit register. Under such conditions, the majority of companies needing additional short-term liquidity did not have the credit solvency and credibility that investors in short-term securities require. At the same time, financial market development in Montenegro remains at a low stage for the appearance of financial intermediaries willing to finance 'venture business' (for example, 'venture funds').⁵ However, Montenegrin companies with sufficient credit solvency may borrow from domestic banks at relatively favorable terms and conditions.⁶ Such conditions, along with inexperience issuing short-term securities, dissuade solvent companies from issuing short-term securities as the means to compensate for lacking liquid funds.

T-bills--traded exclusively on the primary market--are the only short-term securities traded on the Montenegrin money market. Thus, these securities are central to the analysis of the money market in Montenegro.

² Vukajlović-Grba, D. (2003). Monetarna vlast: Međunarodna iskustva i domaći izazovi (Monetary authority: International experience and domestic challenges). *Preduzetnička ekonomija*, 3.

³ La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R., (1998). Law and finance. *The Journal of Political Economy*, 6, 1113-1155.

⁴ Some estimates suggest that the internal debts in Montenegro amount to hundreds of millions of euros. According to CBM data obtained from processing annual financial statements of companies, in 2005 alone, the aggregate lost of the corporate sector amounted to over EUR 250 million.

⁵ Preda, S. (Ed.). (1991). *Funds and portfolio management institutions: An international survey*. Amsterdam: Elsevier Scientific Publishers.

⁶ Center for Entrepreneurship and Economic Development. (2002). *Montenegro business rating 300*. Podgorica: CEED.

2. Legal and Other Prerequisites for Money Market Development

According to the initial Law on Securities,⁷ cheques and bills of exchange were not considered securities (bills of exchange could have been traded objects on the Lombard market), nor were commercial papers (money orders, letters of credit, bills of lading, and warehouse receipts are not traded objects on other securities markets). The Law on Securities did not define commercial notes as securities, however it did not explicitly state they were not securities. Article 2, paragraph 2, item 7 therein specifies the possibility of their issuance, stating that other financial instruments could be considered securities if defined as such in another regulation. In this sense, the Law on Securities created the conditions for the appearance of ‘REPOs’⁸ as money market securities in Montenegro.

The law merely defined certificates of deposit as securities, but initially, banks had no conditions for--and later no interest in--issuing certificates of deposit. T-bills with agreed maturities of up to one year were the only continuously issued financial instrument.

Although the original Law on Securities (until the adoption of its amendments⁹) did not consider T-bills as securities, the law did not mention trading with T-bills on stock exchanges or in any other organized way. Nevertheless, T-bills had the characteristics of securities according to the Law on Obligations.¹⁰ The Amended Law on Securities removed these anomalies from the original Law on Securities, but it also introduced new ones. It contains a confusing definition of the institution authorized to regulate the secondary market of T-bills. Two years after the adoption of the Amended Law on Securities, it remains unclear whether the institution responsible is the Securities and Exchange Commission (SECOM) or the Ministry of Finance of Montenegro. Trade in these securities remains unregulated, both in the legislative and in the institutional sense. The Law’s confusing definition represents one of the basic obstacles to the creation of the T-bills market in Montenegro. However, as time and practice show, it is not the only reason.

In spite of the imprecision of the original Law on Securities in treating T-bills as securities, April 2004’s Decision on the Issuing of T-bills of the Republic of Montenegro¹¹ explicitly allowed trading these instruments on the secondary market. At the same time, short-term government bonds had the attributes of securities according to the Law on Obligations. Thus, secondary trading was allowed, but off-board (bilateral trading between two interested parties). Granted, trading financial instruments and securities on a nascent financial mar-

⁷ *Official Gazette of RoM*, 59/00, 10/01, and 43/05.

⁸ “Repurchase agreement,” an agreement on the repurchase of the previously sold securities from their buyer.

⁹ Amended Law on Securities. *Official Gazette of RoM*, 28/06.

¹⁰ *Official Gazette of SFRY*, 29/78, 39/85, 45/89, and 57/89; and *Official Gazette of FRY*, 31/93.

¹² *Official Gazette of ROM*, 24/04.

ket demands more thorough form and regulations; unfortunately not the case of T-bills in Montenegro.

The Amended Law on Securities corrected some imperfections of the original Law on Securities. Article 2 of the Amended Law introduces the lacking distinction between proprietary securities and debt securities, specifying T-bills issued by the Government of Montenegro as debt securities.

Chapter IVa of the Amended Law on Securities prescribes issuing short-term securities accordingly:

- Article 3, prescribing the issuing, transfer, and registering of short term securities in dematerialized form;
- Article 4, defining the core elements of dematerialized securities;
- Article 5, stipulating that short-term securities must be registered at the Central Depository Agency (CDA), and that the rights and obligations arising from those securities originate as of the moment of their registering at the CDA;
- Article 24, specifying that the decision on issuing must be passed; the appeal should be submitted to the Securities and Exchange Commission of Montenegro (SECOM) for the issue approval, i.e. the issue registering; the issuer should sign a contract with the CDA, prepare the prospect and announce the public invitation for the subscription and payment of securities, i.e. to announce the results of the public sale in accordance with this Law, as well as to register the emission in the registry of issuers with the CDA;
- Article 25, prescribing the contents of the decision on securities issuing;
- Article 26, specifying the obligatory registering of the securities issuers with the SECOM, i.e. their obligation reporting to the SECOM, as well as that market trading can be performed only with securities registered with the SECOM, and
- Article 44g, stipulating that the SECOM proscribes detailed terms and conditions of issuing, registering and trading in short-term debt securities, as well as the obligation of subscribing all issues at the special register of the SECOM. As an exception, the procedure of issuing and selling T-bills--performed by the issuer--are specified by the Ministry of Finance.

As the Amended Law treats T-bills as securities, they are now also traded on the securities market (stock exchanges) in accordance with Article 45 therein. However, since the Ministry of Finance has yet to pass the necessary rules for trading in T-bills, the regulatory preconditions for the development of the T-bills secondary market are left unfulfilled.

Moreover, the Amended Law on Securities, from its enactment until the end of 2006, did not affect the appearance or creation of other short-term securities.

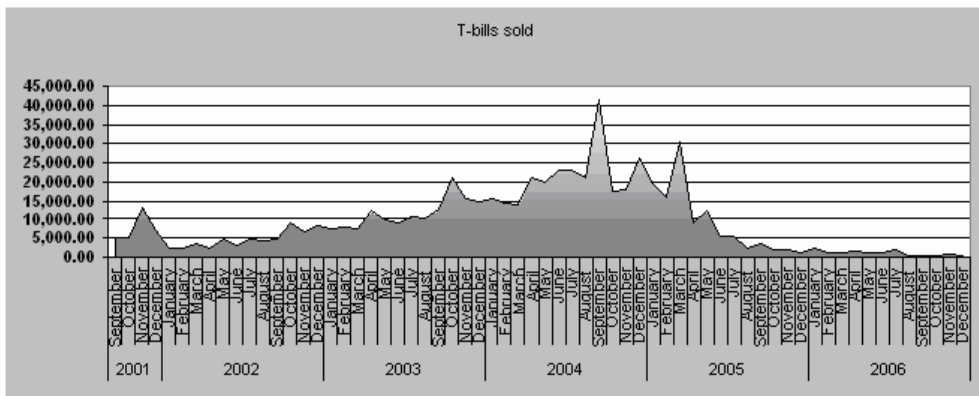
The inter-bank money market, as well as the market of bank guarantees, is not regulated by any legislation. However, a money market implies trade in bank assets; it would be logical to expect the Central Bank of Montenegro to provide the technical support for trade in money. The CBM could also provide the technical support for operating the market of bank guarantees.

3. Short-Term Government Bonds as the Only Available Money Market Instrument

Short-term government bonds (T-bills) issued by the Montenegrin Ministry of Finance Treasury are the sole short-term securities on the money market in Montenegro, traded only on the primary market. Other short-term financial instruments on the Montenegrin financial market, exist but are not traded: bank guarantees and bilateral inter-bank loans.

The Treasury issued the first T-bills in September 2001, in accordance with the Decision on the Issuing of T-bills of the Republic of Montenegro.¹² The beginning of T-bill issuance should have marked a government budget transition to financing under market conditions. The aforementioned Decision enabled issuance of 28-day and 56-day T-bills. The more recent Decision on the Issuing of T-bills of the Republic of Montenegro (April 2004)¹³ allowed issuance of 91-day and 182-day T-bills. June 2004 saw the first auction of 91-day T-bills and the following month introduced that of 182-day T-bills. In 2005, the number of T-bills issued declined; 91-day and 182-day T-bills were only issued occasionally.

Graph 1. Number of T-bills sold, by month, in the period September 2001 – December 2006.



Source: *Bulletin of the Central Bank of Montenegro*, No. 13, January 2007.

¹³ *Official Gazette of ROM*, 43/01.

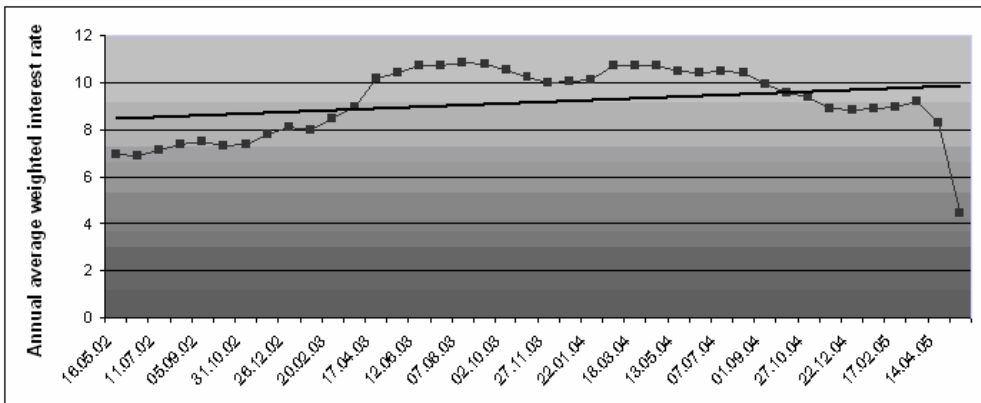
¹⁴ *Official Gazette of ROM*, 24/04.

At the inception of T-bill issuance, September 2001, the Treasury only issued 28-day T-bills; the first auction of 56-day T-bills occurred in March 2002. From July 2002 until the end of the same year, the number of outstanding issues doubled at first, then tripled. The number of T-bill issues continued growing during 2003 and especially during 2004.

The growing necessity of solving short-term liquidity problems in the Government budget was the main cause of this trend. At the same time, growth in demand for T-bills accompanied the growth in numbers of T-bills issued. Amendments to the Decision on the Reserve Requirements of Banks Held with the CBM (passed in early 2003) also supported the expansion of T-bill issuance. These amendments specify that resident banks in Montenegro are allowed to keep the vast majority of their reserve requirements in T-bills (during 2002, this share was 10%, but with the amended Decision¹⁴ it increased to 25%).

Subsequently, demand for T-bills--especially for 28-day T-bills--grew remarkably. This growth, as well as the growth of other auction participants' demand (coupled with growing T-bill offers and timely payment of obligations for T-bills sold) resulted in a significant increase of T-bill interest rates.

Graph 2. *Interest rates on 28-day T-bills from the first auction to April 2005.*



Source: *Bulletin of the Central Bank of Montenegro*, No. 13, January 2007. Note: 28-day T-bills were not issued after April 2005.

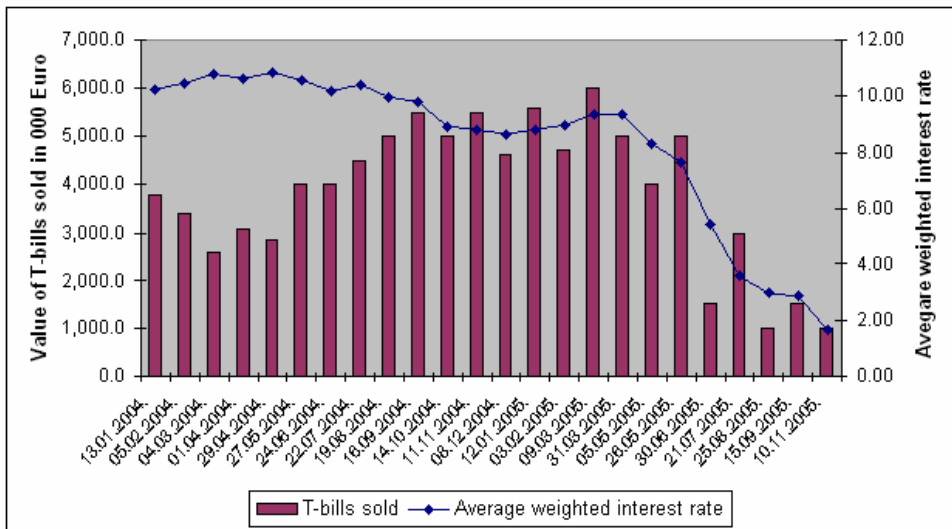
In mid-2004, when foreign investors (financial institutions), domestic private individuals, and legal entities (non-banking institutions) entered the primary market of T-bills, a remarkable downward trend in T-bill interest rates began. When asking for interest on T-bills, the aforementioned investors asked lower rates than Montenegrin banks did because they were not encumbered by the high

¹⁴ *Official Gazette of ROM*, 20/03, 72/03, 50/04, and 14/06.

costs of gathering funds for those investments, as the Montenegrin banks were. In addition to the diversification of investors, transparency of the Government's plans for a future decline in current financing through the issuing of T-bills influenced interest rates on T-bills. In this regard, even if foreign investors had not entered the T-bill market, the interest rates on T-bills would have declined even earlier if the Treasury had introduced an *ex ante* announcement of the auctions schedule.¹⁵

The developments on the T-bill market during 2005 proved the close connection of the T-bills interest rate level with the investors' evaluation of the Government need for funds. Nevertheless, the number of issued T-bills declined in 2005 upon the adoption of the "Strategy for Managing of Montenegrin Public Debt 2005-2007." Considering the relation between T-bills issued and the weighted interest rates at individual auctions, it is easy to conclude that in the cases of higher issues' value, the interest rates were higher, too. In such situations, buyers of those securities concluded that the necessity of Government for additional funds was huge and vice-versa; with T-bill issues of lower value, a large number of investors asked for lower interest rates, aiming to invest their free funds. After the Government announced its intention to gradually lower the value of T-bill issues, interest rates asked from investors also decreased, along with the average weighted interest rates achieved at T-bill auctions.

Graph 3. Total value of 56-day T-bills sold and corresponding average weighted interest rates.



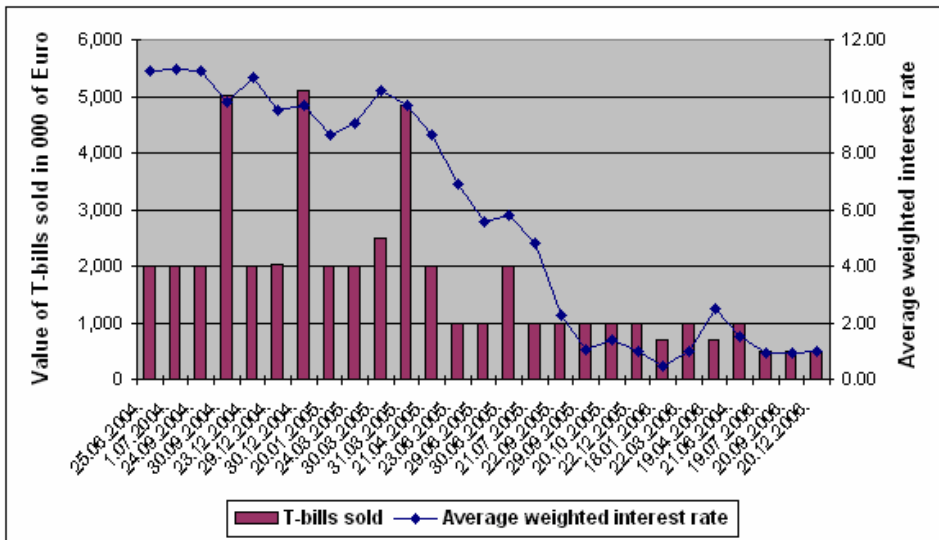
Source: *Bulletin of the Central Bank of Montenegro*, No. 13, January 2007. Note: 56-day T-bills were not issued after November 2005.

¹⁵ Ibbotson, R. G., & Sinquefeld, R. A. (1990). *Stocks, bonds, bills, and inflation 1990 yearbook (Sbbi) yearbook*. Chicago: Ibbotson Associates.

The decreased offer resulted in the decreased demand for T-bills, primarily that of foreign investors. As T-bill interest rates fell to such a low level, the demand of foreign investors fell because investors could not make any profit from their investments after having paid all the expenses for investing in T-bills.¹⁶

These trends have been recorded with interest rates on all maturing T-bills (28-day, 56-day, 91-day, and 182-day), reflected in the corresponding graphs.

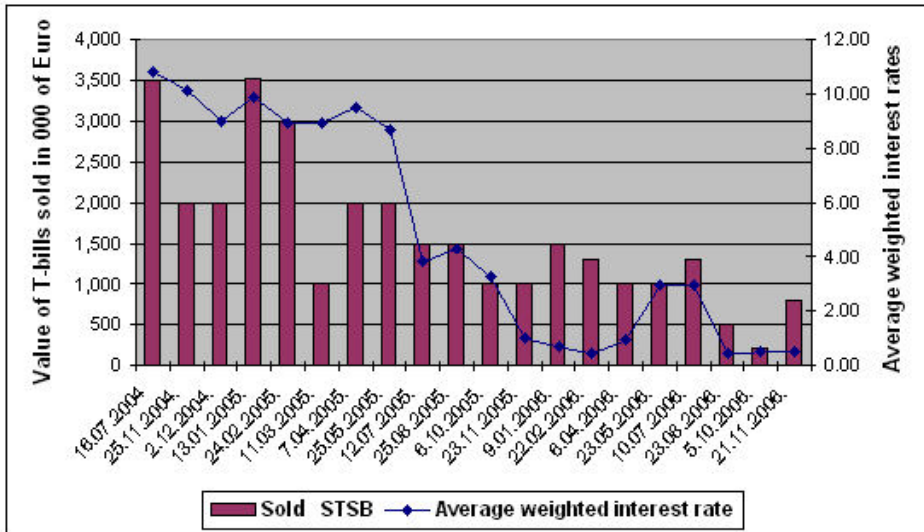
Graph 4. Total value of 91-day T-bills sold and corresponding average weighted interest rates from the first auction until December 2006.



Source: Bulletin of the Central Bank of Montenegro, No. 13, January 2007.

¹⁶ These expenses refer to expenditures for payment operations abroad (performed through banks), for transaction registering in the CDA, and for broker and dealer services.

Graph 5. Total value of 182-day T-bills sold and corresponding average weighted interest rates from first auction to December 2006.



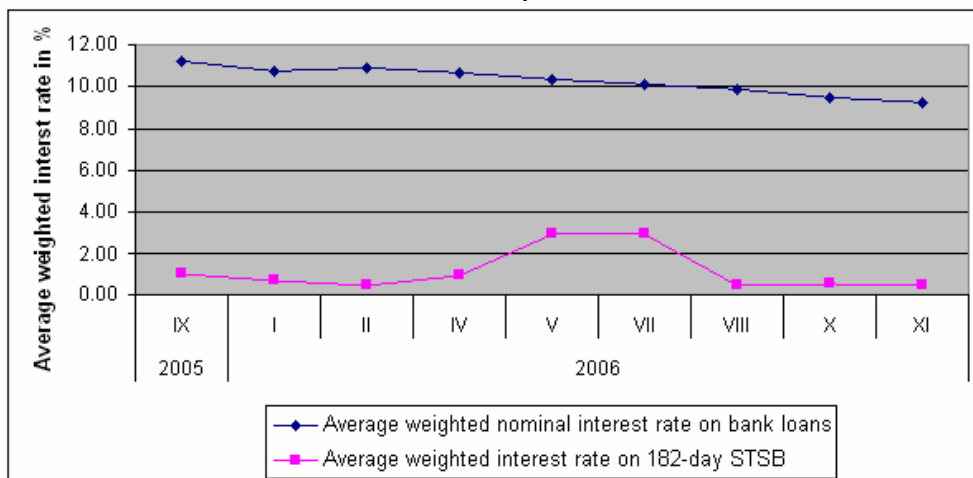
Source: Bulletin of the Central Bank of Montenegro, No. 13, January 2007.

T-bill interest rates are primarily conditioned by the Government's demand for liquid funds, the transparency of its operations, and the Government's credibility regarding its payments for T-bills issued, whereas T-bill liquidity is not critical for the creation of interest rates on these securities.

In this regard, T-bill interest rates have their own movement--primarily dependent on investors' assessments of the Government's need for additional liquidity--whereas the investment risk T-bills bear is rather high, regardless of their low liquidity. The liquidity of all T-bill types equaled zero for the entire period since their initial issuance. Even if it was possible, the CBM participating in the secondary T-bill market would not have affected the level of interest rates on T-bills because of the high liquidity of investors in these securities.¹⁷

¹⁷ Vukajlović-Grba, D. (2003). Monetarna vlast: Međunarodna iskustva i domaći izazovi (Monetary authority: International experience and domestic challenges). *Preduzetnička ekonomija*, 3.

Graph 6. Comparison of the average weighted nominal interest rates on bank loans and 182-day T-bills.



Source: *Bulletin of the Central Bank of Montenegro*, No. 13, January 2007. Note: The average weighted nominal interest rates on bank loans are only shown for those months when the 182-day T-bills were issued.

Unlike partial dollarization, under the conditions of full dollarization (that is, euroization), when short-term Government securities are not used for monetary policy, the interest rate on those securities cannot affect the level of interest rates on the financial market--especially bank lending interest rates. At the same time, the level of bank lending interest rates cannot influence the level of interest rates on short-term Government securities under such conditions. The difference between the level of T-bill interest rates and the average weighted bank lending interest rates (shown in Graph 6), and the latter remains rather high regardless of their continuous decrease in the last five years.¹⁸

4. Investors on the Short-Term Government Bonds Market

Unlike government securities markets in other countries, participants in Montenegrin T-bill auctions may be private individuals as well as legal entities that can obtain a payment guarantee for their bid and are registered with the CDA. However, a T-bills investor may also apply for the auction through a representative registered with the CDA who can place the payment guarantee for the investor in question. Participants in the primary T-bill market include: the Government (as issuer) and the Central Bank of Montenegro (as the Government's fiscal agent

¹⁸ Average weighted bank loan interest rates decreased from 24% in 2001 (the highest average annual interest rate) to 9.06% in December 2006. This was the level of average weighted interest rates for all types of borrowers (based on data from the Regulatory Credit Bureau of the CBM).

facilitating T-bill auctions¹⁹); the T-bill investor side includes: banks, institutional investors²⁰ (mostly insurance companies, then stock exchanges, brokers, and dealers--‘licensed financial market participants’), legal entities outside the financial sector, and private individuals. To be sure, domestic banks have been the most important T-bill investors over the course of Montenegrin T-bill issuance.²¹ Financial institutions from abroad (mostly banks) appeared as investors on the primary T-bill market during 2004, attracted by high T-bill interest rates and safety of T-bill investment (that the Ministry of Finance created by timely payments of their debt for T-bills).²² Upon the aforementioned interest rate decline, foreign investors withdrew from the market,²³ leaving domestic banks as the main investors on the primary T-bill market.

Montenegrin banks are the biggest T-bill investors due to their continuously high liquidity and their ability to keep a portion of their reserve requirements in T-bills. Banks’ such high level of liquidity is the result of growing deposits--as the main sources of bank funds (deposit growth is based on growth of economic activity, abatement of the informal economy, and an inflow of privatization revenues, especially from abroad). Nevertheless, banks’ funds also increased due to borrowing from abroad, mostly from their mother-banks.²⁴ Under such circumstances, banks fight the high opportunity costs generated by their high liquidity by seeking the lowest risk investments possible. One such investment is the short-term Government bonds of the Montenegrin Treasury.²⁵

Upon the initial T-bill issuing, investors did not know whether the Government would pay its liabilities on time for issued T-bills. Accordingly, investors expected T-bill interest rates to be high (they reached the maximum level of

¹⁹ The chosen model of selling short-term Government bonds is auction through both competitive and non-competitive bids. Short-term government bonds are issued in a dematerialized form, their nominal value being EUR 500 and EUR 100, and are registered in the Central Depository Agency of RoM.

²⁰ Private: voluntary pension funds have not been organized yet (the Law on Voluntary Pension Funds was adopted just recently) and the Government Pension and Disability Insurance Fund may not invest in the financial market, i.e., on the money market. Investment funds have occasionally bought T-bills.

²¹ Sometimes the banks bought the whole issue of T-bills (usually 28-day T-bills).

²² These investors’ demand mostly oriented toward 91-day and 182-day T-bills, and required lower interest rates than sought by domestic investors.

²³ Wolde, R. T., Laise, E., & McDowell, D. (2001, August 17). How to fix your portfolio. *Smart Money*.

²⁴ Alternatively, such high liquidity may have originated from relatively rigorous criteria regarding banks’ liquidity, and especially regarding loan offers. These criteria prevent banks from exposing themselves to rather risky investments, leaving them sizable amounts of non-invested money. Regardless, banks still operate under conditions where the majority of projects competing for bank loans are highly risky regarding credit risk, client risk, and performance risk.

²⁵ Characteristic to all transition and developing economies, banks generate great interest in investing in their government securities. Such a trend usually suggests: 1) the economy still operates in rather unstable conditions, making bank loans to companies high risk investments, and 2) some external or internal bank regulations prevent banks from undertaking very risky investments.

11.51%). However, when the Government established timely payment for issued T-bills, their interest rates did not decline. At first this was considered the result of T-bills' low liquidity. The absence of a T-bill secondary market made them illiquid; that is, unattractive to investors with low risk tolerance and troubled liquidity.²⁶ The absence of the T-bill secondary market was considered due to inadequate regulation--specifically, ineffective harmonization of the Law on Securities and the Decision on the Issuing of Government Bonds. Adequate laws and enabling regulations must support any financial instrument or securities market to develop by creating the regulatory conditions for both primary and secondary trading.²⁷ Nevertheless, the Amended Law on Securities corrected this anomaly, but the secondary T-bills market has not developed yet because the necessary enabling regulations have not been adopted. If the creation of a secondary market and a liquidity of T-bills were of decisive importance for their investors, they would probably pressure the Government to adopt the relevant regulations. However, it seems that the main cause of the T-bill secondary market's dilatory development is the high liquidity of investors and their liberty to keep T-bills until maturity.

At the same time, for the majority of companies with low liquidity, solvent demand for these financial instruments did not exist. Under different circumstances, more companies would participate in T-bill auctions. T-bill demand is also low because the Central Bank of Montenegro is not an issuing monetary authority and does not use open market operations to conduct monetary policy. If the CBM was the issuing monetary authority, the controversial instructions prescribed in the Law on Securities would not likely have occurred at all (or would have been changed much earlier). Meanwhile, the liquidity of companies improved, but an accelerated growth of share prices on Montenegrin stock exchanges also commenced. This process absorbed the sufficient liquidity of companies and additionally lowered their interest in investing in short-term securities.

5. Other Money Market Instruments in Montenegro

Regardless, inter-bank loans exist, but are performed outside an organized market (as bilateral agreements between banks).²⁸ The CBM and its information technology (IT) facilities do not intermediate these transactions and the interest rates on these loans are agreed under non-competitive conditions.

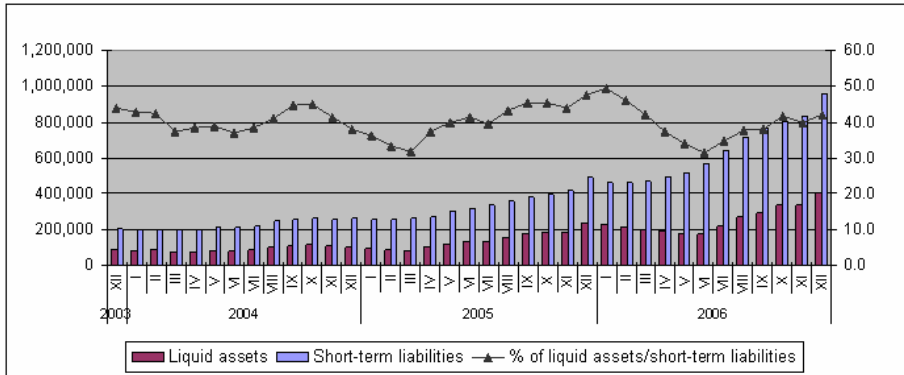
²⁶ Ristić, Ž. (1990). *Tržište novca*. Belgrade: Privredni Pregled.

²⁷ Bossone, B., & Promisel, L. (1998). Strengthening financial systems in developing countries: The case for incentives-based financial sector reform. *World Bank Working Paper*. Washington, DC: World Bank.

²⁸ Dabić, S. (1999). *Hartije od vrijednosti (Securities)*. Belgrade: IQ Media.

A rather large number of central banks with issuing power use the inter-bank interest rate as an anchor for conducting monetary policy.²⁹ Under such conditions, the monetary authority is interested in organizing the inter-bank market, aiming to create the conditions for reaching the agreed interest rate under competitive conditions. However, the CBM is an authority without issuing power³⁰ and cannot set the anchor interest rate. For these reasons, the CBM--although being the highest monetary authority--has no direct interest in establishing the inter-bank market.³¹ Concurrently, bank liquidity remains rather high, and banks do not express particular interest in establishing the inter-bank market.³² The following graphs reflect this situation, showing liquid assets and short-term liabilities of banks, that is, available assets and banks effected payments.³³

Graph 7. *Liquid assets and short-term liabilities (in thousands of EUR) and their relative position (in percent), for the period December 2003–December 2006.*



Source: *Bulletin of the Central Bank of Montenegro*, No. 13, January 2007.

²⁹ Fabris, N. (2006). *Centralno bankarstvo u teoriji i praksi (Central banking in theory and practice)*. Podgorica: CBM.

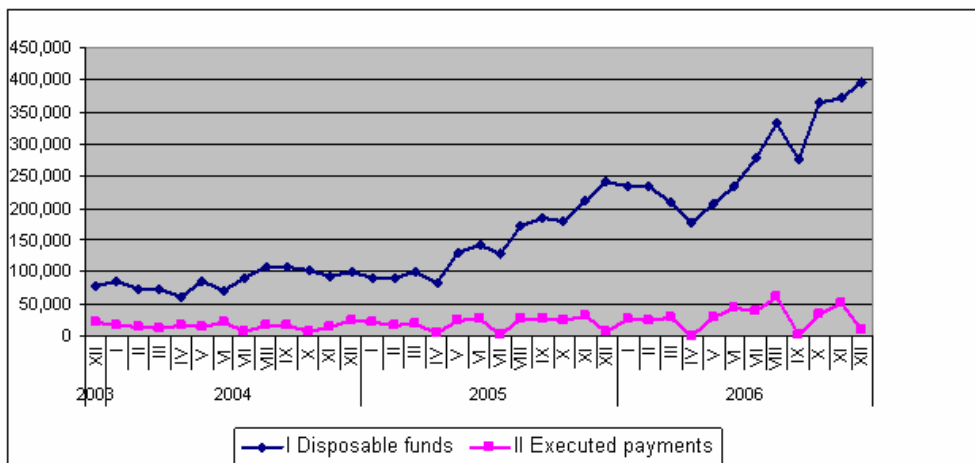
³⁰ Law on the Central Bank of Montenegro. *Official Gazette of RoM*, 52/00, 53/00, and 47/01.

³¹ Fabris, N., Vukajlović-Grba, D., Radunović, T., & Janković, J. (2004). Economic policy in dollarization. *CBM Working Paper*. Podgorica: CBM.

³² The inter-bank loans are extended occasionally and are disorganized, although the need for institutionalization persists in the banking system. During 2003, the project of establishing the money market in Montenegro was completed. The project also envisages trading with money, but the project was not adopted until May 2007. In the spring of 2004, the Montenegrin Association of Banks addressed the proposal to the Central Bank of Montenegro, where it was suggested that the CBM should organize money trading with short-term financial means. The Central Bank of Montenegro responded to this proposal only at the end of 2004, after the introduction of the Real Time Gross Settlement (RTGS) System. This system performs settlements of inter-bank payments in real time and represents one of the necessary preconditions for a successful organization of trading with money and with short-term financial means. However, after of the creation of technical conditions for organizing the money market and due to their continuously increasing liquidity over time, banks did not insist on the proposal of organizing the money market within the CBM or anywhere else.

³³ Central Bank of Montenegro. (2007, March). *Chief Economist annual report for 2006*. Podgorica: CBM.

Graph 8. Disposable funds and effected payments of banks, on the last day of the month (in thousands of EUR), in the period December 2003–December 2006.



Source: Bulletin of the Central Bank of Montenegro, No. 13, January 2007.

Inter-bank market development depends on several factors, primarily on banks' future liquidity.³⁴ Decreased liquidity could exert pressure on the CBM to institutionalize inter-bank market development, resulting in a rapid creation of both regular and institutional conditions for inter-bank trading (especially since the CBM already possesses adequate IT support: hardware, software, and trained staff).

Table 1. Share of domestic bank loans extended to financial institutions in Montenegro as a percentage of total loans, December 2002–December 2006 (in thousands of EUR).

	2002.	2003.	2004.	2005.	2006.			
	XII	XII	XII	XII	III	VI	IX	XII
Financial institutions	788	1,695	3,854	136	1,424	4,710	3,737	6,488
Banks	35	1,525	1,000	37	533	1,051	48	544
Other financial institutions	753	170	2,854	99	891	3,659	3,689	5,944
TOTAL	124,663	200,625	281,483	375,941	456,446	559,322	653,060	847,166
Share of loans to financial institutions as a percentage of total loans	0.6%	0.8%	1.4%	0.04%	0.3%	0.8%	0.6%	0.8%

Source: Bulletin of the Central Bank of Montenegro, No. 13, January 2007.

³⁴ Oomes, N., & Ohnsorge, F. (2005, July). Money demand and inflation in dollarized economies: The case of Russia. *International Monetary Fund Working Paper, 05/144*. Washington, DC: IMF.

Repurchase agreements (REPOs) do not exist in Montenegro. The Central Bank of Montenegro certainly does not extend loans based on the collateral of T-bills, except for intra-day and overnight loans.³⁵

Companies do not issue *commercial papers*, so they also do not exist as trading material.

Tradable certificates of deposit--whose issuing as the money market securities is allowed by the Law on Securities--also do not exist on the Montenegrin money market, mostly due to the high liquidity of banks.

Bank guarantees, although used as a form of guarantee for payment by debtors, are not traded, i.e. their owner could not sell them in a case of liquidity shortage since the secondary market for bank guarantees does not exist in Montenegro.

6. Problems and Recommendations

Significantly, the T-bill market and the development of other money market segments in Montenegro were not formalized and regulated in the Law on Securities. Frankly, several conditions hindered such primary markets for years.

During composition of the Law on Securities (2001), the financial market situation was rather troublesome: bad loans burdened the banking system and low economic activity, large inter-company debts, and a tendency towards hazardous finances persisted. Accordingly, the creators of the Law on Securities correctly assessed that conditions were inappropriate to create the money market. Namely, the liquidity of Montenegrin banks and confidence in them were very low and the economy was in bad condition from many years of hyperinflation, internationally imposed sanctions, and a widespread informal economy and black market. The judiciary functioned poorly and inefficiently, causing a debtor-creditor crisis. The state itself contributed to this crisis as one of the largest debtors for social contributions that were not paid during the 1990s. The total amount of state debt is impossible to cast precisely, but is assumed to exceed EUR 100 million. Unsurprisingly, the state has never pleaded for the settlement of bilateral and multilateral debts and the establishment of clear relations between economic subjects. These conditions--and persistent high inflation--created an inconducive environment for organizing the money market.

The only right way to establish the money market seemed, therefore, through a reformed banking system, tightened fiscal discipline, an apprehended informal sector, a lowered inflation rate, settled inter-company debts, and im-

³⁵ Specific conditions of extending intra-day and overnight loans are prescribed in the Decision on More Specific Terms and Conditions and of Use of Bank's Assets Approved by the Central Bank of Montenegro for the Purpose of Liquidity Maintenance, *Official Gazette of ROM*, 02/02. According to the Law on The Central Bank of Montenegro, the CBM cannot extend loans for a period longer than one day, conditioned by full dollarization as the legal monetary regime in Montenegro.

proved laws and other conditions for a more efficient judiciary. These positive changes are necessary to create the preconditions of money market development, thus enabling a successful transfer of short-term finances from money-sufficient to money-deficient sectors in the economy.³⁶ A few of these conditions have been met: the banking system situation has improved, resulting in regained trust and high rates of increase in lending and deposit rates; fiscal discipline has been established, taxes have been lowered while their collection has increased, and the budget deficit share in GDP has declined to below the Maastricht criterion (3%); the inflation rate's level has decreased from high three-digit percentages five years ago to only 2% in 2006, and the informal sector's share has also declined (to below 20%).

The new Law on Enforcement Procedure was adopted, however, Montenegro's court system is still not efficient enough and litigations last for years. The judiciary's unfavorable financial position, insufficient independence, and a shortage of judges--among other reasons--slow litigation procedures, restraining the already low level of protection of creditor rights. Therefore, all the necessary preconditions of money market development in Montenegro remain unfulfilled. Further, the legal protection of contractual rights and an efficient settlement of claims are the most pressing prerequisites, especially since the number of highly solvent companies remains relatively small (low-solvency companies still prevail). The latter--with their poor settlement of claims for issued securities under circumstances of long litigations and poor creditor rights protection--may compromise the introduction and development of the short-term securities market.

Additionally, perhaps the most important reason for the lack of pressure to initiate money market development in Montenegro is the prevalence of short-term bank loans as one of the main sources of short-term financial gap financing. Consequently, alongside slowly developing conditions of safety and the provision of liabilities, serious intentions and stimuli for the development of other short-term financial instruments and securities have lagged. In short, the Ministry of Finance started issuing T-bills to collect short-term money when the state could not obtain inexpensive, low-interest loans from state-owned banks. As Montenegrin banks privatized and international financial organizations (especially the IMF) exerted reform pressures, the state lost its preferential treatment in bank loan interest rates. Short-term Government bonds were introduced as an alternative means to acquire finances³⁷ and tested the state's ability to pay its liabilities for the bonds issued.

Finally, through high deposit interest rates, banks negatively affect the creation of short-term commercial securities. Regardless, under the given cir-

³⁶ Siegel, A. M., & Morris, K. M. (1995). *U obliku novca (In the shape of money)*. (S. Dabić, Trans.). Belgrade: IQ Media.

³⁷ During T-bill introduction to financial markets, their interest rates were lower than lending interest rates that banks--mostly already privatised--asked for loans disbursed to the state and its agencies.

cumstances, every company--no matter how solvent and successful--should offer an interest rate higher than the deposit interest rate, anticipating selling the issued short-term securities.³⁸ Despite their continuous decline, deposit interest rates remain relatively high in Montenegro due to strong competition between banks in attracting deposits. Therefore, the expenses of companies for acquiring additional short-term finances via issuing short-term securities would remain high, followed by the threat of the issues' failure.³⁹ Notably, until 2007 no bank in Montenegro--nor any other type of financial intermediary--dealt with investment banking; that is, none dealt with the redemption of total securities issues (whether for the purpose of holding these securities until their maturity date or selling them on the secondary market).⁴⁰

Also, investors' lack of trust in the Treasury's capability and willingness to pay its liabilities for issued T-bills accompanied T-bills' market introduction. Even in highly developed countries with established money markets (Germany, for example), companies prefer bank loans over issuing short-term securities to acquire short-term financial means.⁴¹ In such countries, however, owners of large amounts of money available in the short term prefer deposit accounts with banks rather than investing in short-term securities.⁴²

Sectors lacking finances have yet to pressure for developing primary markets of short-term commercial papers, short-term bonds, and other short-term securities for several more reasons: 1) the Republic's unresolved debtor-creditor crisis; 2) the judiciary's poor efficiency and a low level of legal protection of contractual rights; 3) a low liquidity of companies as the market participants; 4) a low level of creditworthiness and credibility of the majority of companies--potential short-term securities issuers;⁴³ 5) the lack of types of investors such as investment banks and institutional investors. Under such circumstances, only few holders of surplus liquidity considered buying commercial short-term securities because they feared that the issuer would not be solvent enough at maturity and that they would scarcely find a buyer on the secondary market for such a

³⁸ Saunders, A., & Millon Cornett, M. (2001). *Financial markets and institutions: A modern perspective*. New York: McGraw-Hill/Irwin.

³⁹ Kadlec, C., (2001, October). Don't let a downmarket spin you. *Mutual Funds*, 7(12). New York: J. & W. Seligman & Co.

⁴⁰ According to the Law on Securities, authorized financial markets intermediaries licenced by the Securities and Exchange Commission can perform investment banking. According to the same Law, a commercial bank must first get approval from the CBM in order to be licenced by the Securities and Exchange Commission to perform investment banking operations.

⁴¹ Singh, A. (1995). Corporate financial patterns in industrializing economies: A comparative international study. *International Finance Corporation Technical Paper*, 2. Washington, DC: IFC.

⁴² To question cause versus consequence: has the absence of short-term securities left bank deposits the only option for the investment of excess liquidity, or has the preference of bank savings over investments on financial markets left bank loans the only source for companies' external financing?

⁴³ However, issuing short-term securities would be possible within newly established companies, regardless their lack of any records of their business performance.

security.⁴⁴ Likely for the same reasons, not even venture investment funds or other financial intermediaries specializing in very risky investments took hold--the risk was simply too high. Additionally, in 2005 and 2006, a high and accelerated growth in stock prices at both Montenegrin stock exchanges contributed to underdevelopment of the money market. Such trends directed excess liquidity to investments in stocks--regardless of their value and quality--expecting capital gains.⁴⁵ Considering that some stock prices increased by over two-hundred percent in a month or two during the observed period, even short-term funds clearly had the opportunity to yield profit from investments in stocks on Montenegrin stock exchanges. Consequently, the stock exchanges in Montenegro assumed the role of the money market in the sense of creating opportunities for profitable short-term investments in relatively liquid securities. Regardless, stock exchanges play the role of the money market under very risky conditions, as the price rises of the vast majority of stocks have been volatile and characterized by significant price decreases in the short-run.

In spite of the traditional market tendency and the aforementioned reasons for the money market's slow development, the fact remains that a wider range of short-term securities would be the alternative to bank loans and a decrease in bank lending interest rates.⁴⁶ On the one hand, short-term securities would have been the alternative to bank loans (the more liquid, the more competitive); on the other hand, short-term securities would decrease deposits because the owners of excess liquidity would invest it in short-term securities. Thus banks would face a decline in their liquid liabilities, reducing their need to cover opportunity costs for holding liquidity with high interest rates. Competition of other short-term financial instruments--both regarding offer and demand--would probably affect the much desired and expected decline in bank lending interest rates.

Conclusion

In conclusion, the key problems and imperfections of trading short-term financial means persist in Montenegro. Granted, if inadequate legislation had been considered the major barrier to that trade, then the enactment of the Amended Law on Securities removed all doubts. Nevertheless, even treating some of the short-term financial instruments as securities under this Law (enabling their sec-

⁴⁴ Kadlec, C., (2001, October). Don't let a downmarket spin you. *Mutual Funds*, 7(12). New York: J. & W. Seligman & Co.

⁴⁵ Popović, S., Fabris, N., Vukajlović-Grba, D., Mitrović-Mijatović, M., Vlahović, A., Bakić, G. et al. (2007). Analiza finansijskog tržišta u Crnoj Gori. *CBM Research & Statistics Department Working Paper*, 12. Podgorica: CBM.

⁴⁶ Goldsmith, R. (1969). *Financial structure and development*. New Haven, CT: Yale University Press.

ondary trading), there remains no issuance of such short-term securities. It should be noted that enabling regulations allowing secondary trading of T-bills have yet to be adopted. Nonetheless, their enactment would likely be encouraged in the case of offer of--or demand for--these securities on the secondary market.

The legislation itself, while the necessary precondition, cannot stimulate the issuing and development of the securities market. A decrease in banks' liquidity, forcing banks to issue short-term securities as the means to acquire funds to finance loans may stimulate securities market development. Nevertheless, even if Montenegrin banks face this decrease,⁴⁷ as long as banks' lending interest rates remain high and country risk and borrower risk remain acceptable to foreign creditors, domestic banks may easily obtain credits from foreign banks to finance loans.

A decline in domestic banks' lending interest rates may circumvent this scenario. Only increased stability in domestic debtor-creditor relations--via improved court efficiency, bilateral and multilateral debt settlement, and improved corporate performance transparency (regarding creditworthiness, indebtedness, and the like)--could establish such conditions. Consequently, this begs another question: in the case of bank lending interest rates' decline, would companies be interested in issuing short-term securities at all? Yes, they would; if banks' funds decline (usually following a decrease in deposit interest rates) accompanied lower bank lending interest rates.

Even as companies lack interest in issuing short-term securities if banks' funds decline, we can expect that banks will create the money market by issuing their own short-term securities and/or by establishing investment funds. Investment funds established by banks--among other investments in their portfolios--could invest their capital in short-term bank-issued securities. Considering the general lack of serious attempts adequately address large internal debts and poor court efficiency (solutions that are preconditions for issuing short-term commercial securities and a growth in demand for them), we may not expect the development of the money market in Montenegro in the near future.

List of Abbreviations

CBM	Central Bank of Montenegro
CDA	Central Depository Agency
EUR	Euro
GDP	Gross Domestic Product
FRY	Federal Republic of Yugoslavia
IT	Information Technology
REPO	Repurchase Agreement

⁴⁷ For example, a decrease in deposits due to the shift of free financial funds to private pension funds' and mutual funds' end or close could decrease banks' liquidity.

RoM	Republic of Montenegro
RTGS	Real Time Gross Settlement
SECOM	Security and Exchange Commission
SFRY	Socialist Federal Republic of Yugoslavia

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