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Investing in rural people

# President’s report

# Proposed loan and grant to Montenegro for the Rural Clustering and Transformation Project

Note to Executive Board representatives

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For: Approval

# Contents



## Appendices

# Abbreviations and acronyms

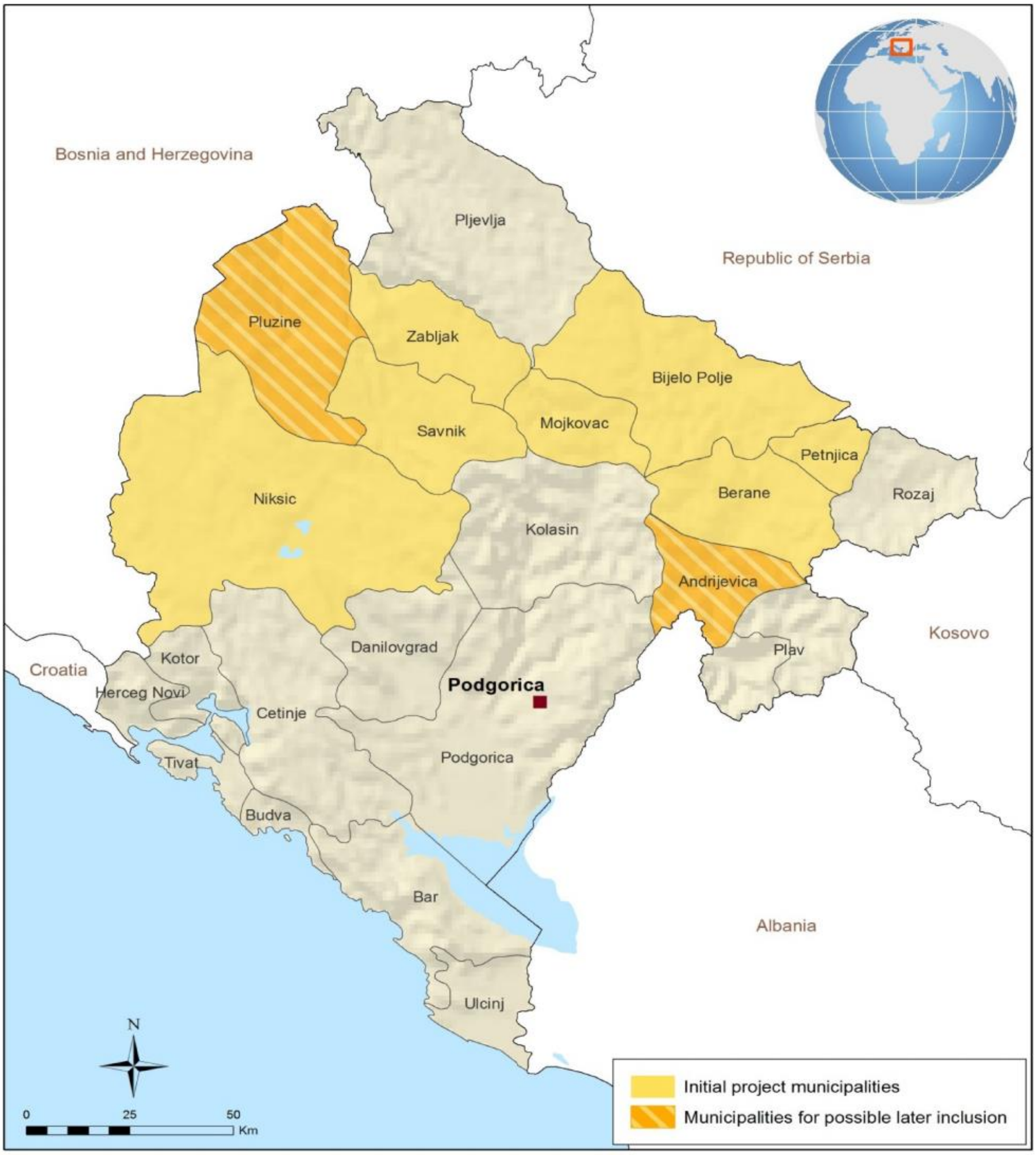
| | |
|---|---|
| ASAP | Adaptation for Smallholder Agriculture Programme |
| AWP/B | annual workplan and budget |
| KM | knowledge management |
| MARD | Ministry of Agriculture and Rural Development |
| M&E | monitoring and evaluation |
| PCU | project coordination unit |
| PSC | project steering committee |
| RCTP | Rural Clustering and Transformation Project |
| SMEs | small and medium-sized enterprises |
| VC | value chain |
| VCF | value chain fund |

# Map of the project area

**Montenegro**

Rural Clustering and Transformation Project (RCTP)

*President's report*




The designations employed and the presentation of the material in this map do not imply the expression of any opinion whatsoever on the part of IFAD concerning the delimitation of the frontiers or boundaries, or the authorities thereof.

IFAD *Map compiled by IFAD* | 26-01-2017

# Montenegro

# Rural Clustering and Transformation Project

## Financing summary

| | |
|---|---|
| **Initiating institution:** | IFAD |
| **Borrower:** | Montenegro |
| **Executing agency:** | Ministry of Agriculture and Rural Development (MARD) |
| **Total project cost:** | EUR 13.61 million (equivalent to approximately US$14.48 million) |
| **Amount of IFAD loan:** | EUR 3.88 million (equivalent to approximately US$4.12 million) |
| **Amount of grant under the Adaptation for Smallholder Agriculture Programme (ASAP):** | EUR 1.88 million (equivalent to approximately US$2.0 million) |
| **Terms of IFAD loan:** | Ordinary: Maturity period of 15 years, including a grace period of 3 years, with an interest rate per annum equivalent to 100 per cent of the variable reference interest rate, as determined annually by the Executive Board |
| **Cofinancier(s):** | Small and medium-sized enterprises (SMEs) |
| **Amount of cofinancing:** | EUR 0.62 million |
| **Contribution of borrower:** | EUR 5.62 million |
| **Contribution of beneficiaries:** | EUR 1.61 million |
| **Appraising institution:** | IFAD |
| **Cooperating institution:** | Directly supervised by IFAD |

## Recommendation for approval

The Executive Board is invited to approve the recommendation for the proposed financing to Montenegro for the Rural Clustering and Transformation Project, as contained in paragraph 41.

# Proposed loan and grant to Montenegro for the Rural Clustering and Transformation Project

## I. Strategic context and rationale

### A. Country and rural development and poverty context

1. Montenegro is one of the smallest countries in Europe, with an area of 13,800 km$^2$ and a population of 622,000. The country recovered impressively from the disastrous events that engulfed most of South-East Europe in the 1990s. The economy has grown to regain much of the loss, poverty has fallen, the country managed a peaceful dissolution of the state union with Serbia in 2006, its governance standards have improved, and ethnic minorities are protected well by regional standards. It is against this background that Montenegro has made substantial progress towards European Union accession, which will ensure permanent access to the world's largest market. At the earliest, Montenegro could join the EU in 2021.

2. However, most of the economic growth has benefited coastal areas and the adjacent plains, where a consistent rise in tourism numbers has catalysed investments in the service and construction sectors associated with the hospitality industry. More than 1.6 million tourists visited Montenegro in 2016, generating more than EUR 750 million in income. The effect has been to make the coastal municipalities and those around the capital, Podgorica, the richest in the country, with low poverty, high employment and robust competitiveness. But the flip side is found in the northern mountainous region, where less than 2 per cent of tourists venture. Here, the context is characterized by depopulation, higher poverty and limited employment opportunities. Agriculture remains the key economic activity, but with low productivity, limited by small-scale production and inconsistent volumes and quality. Thus Montenegro imports 10 times more foodstuffs than it exports. The northern mountainous areas are also disadvantaged in terms of connectivity, with poor infrastructure that is hard-to-impossible to negotiate during winter and periods of heavy rainfall.

3. Climate change is further aggravating the situation in northern Montenegro, not least due to its reliance on the most climate-vulnerable sector, agriculture. Increased severity and irregularity of rainfall is being observed and is expected to increase as temperatures rise. This will put pressure on both livestock and crop production, with smallholders being particularly exposed. Moreover, the extreme weather events also have a detrimental effect on the region's infrastructure, with many gravel roads being eroded by flooding and heavy rains. In sum, Montenegro is developing into an increasingly unequal dual economy, with climate change deepening the division, leaving the poor rural mountainous regions further behind.

### B. Rationale and alignment with government priorities and RB-COSOP

4. Montenegro's 2015 membership in IFAD and its subsequent request for assistance in designing and financing the RCTP should be seen in the context just described.

This comes at a critical juncture in Montenegro's short history, at a time when the prospect of joining the European Union is coupled with slowing growth, rising inequality and emigration, especially from rural areas. In other words, poor rural mountainous regions and the rural smallholders/households living there are already largely excluded from agricultural markets, and they risk being further left behind by the process of EU accession.

5. Mitigation measures will be needed to stop and eventually reverse the decline of the northern region, and IFAD is seen as a partner uniquely positioned to facilitate a deliberate, policy-driven rural transformation. As an upper-middle-income country, Montenegro has perhaps only a limited need to draw on IFAD resources as a source of complementary funding to its public expenditure. Its requirement of IFAD is rather one of "finance plus", where the additional dimension is the experience, skills and knowledge management (KM) that IFAD can bring. The process of European Union accession is a complex one, and the capacity of the Ministry of Agriculture and Rural Development (MARD) is stretched thin in addressing the many policy, legislative and administrative requirements associated with it. In this context, MARD has limited capacity to take on the additional task of articulating and operationalizing a strategy to promote an inclusive approach to agricultural and rural development that incorporates and responds to the challenges faced by poor smallholder families. The Government of Montenegro is looking to IFAD to assist in filling this gap and to use the RCTP as a vehicle to test and promote new approaches that can provide the basis for future public policy, strategy and investment.

# II. Project description

## A. Project area and target group

6. The project will focus on rural areas in the northern mountainous region, where farmland is mostly over 600 metres above sea level. The initial selection includes Berane, Bijelo Polje, Mojkovac, Niksic, Petnjica, Savnik and Zabljak. At a later stage, Andrijevica and Pluzine may be included, pending funding, market opportunities and potential impact on smallholders. The total RCTP outreach is estimated at 4,600 households (or some 16,100 individuals). In line with IFAD's mandate, the population profile in northern Montenegro and project objectives, the RCTP target groups are: (i) semi-subsistence farmers; (ii) commercial and economically active smallholders and small-scale processors; and, more indirectly, (iii) key private-sector actors along the selected value chains (VCs). Targeting will take place in a three-stage process: (a) cluster selection; (b) geographical targeting; and (c) beneficiary selection, with specific targeting measures to ensure outreach to poorer smallholders, women and youth.

## B. Project development objective

7. The overall goal of the RCTP is to contribute to the transformation of smallholders' livelihoods in northern Montenegro, enabling them to become more competitive and resilient to climate change. The development objective is to increase the participation of poor smallholders in inclusive, profitable and environmentally sustainable VCs, and to enhance the benefits they derive from these.

## C. Components/outcomes

8. The RCTP's three outcomes are: (i) improved commercial relations between smallholders, suppliers and buyers, supported by relevant public actors, which will catalyse increased investment in the selected VCs; (ii) improved access by smallholders to resilient water schemes and farm access roads that support the selected VCs; and (iii) gradual incorporation of lessons from successful project approaches into national practices and policies. The latter outcome is thus fully reliant on lessons generated by outcomes 1 and 2.

Component/outcome 1. VC clustering for resilient rural transformation

9. The project will focus on promoting the expansion of competitive clusters for a portfolio of products with confirmed market potential and comparative advantages for smallholder production. The four initial prioritized products/VCs are cultivated berries, cheese, meat and seed potatoes. A critical consideration during design has been the potential for a strong upside for individual smallholders and younger farmers to invest, expand and improve their production. Careful consideration has been given to viable “investment pathways” for smallholders in each of the prioritized products. While the four initial products offer immediate opportunities, it is expected that during implementation additional opportunities will emerge, often for products that are produced only on a minimal scale at present, but that have both favourable market conditions and a comparative advantage for smallholder production.

10. The clusters will be geographical concentrations of interconnected producers, businesses, suppliers and associated institutions. This creates direct and indirect synergy among them, resulting in market linkages. Three clusters with the promising VCs mentioned have been initially identified: livestock (primarily sheep/goats for meat, but also high-value dairy), cultivated berries and seed potatoes, with possible later expansion of the product range and geographical coverage. Activities underlying the cluster development process will include: (i) multistakeholder cluster meetings, where the actors will discuss challenges and opportunities and develop an action plan together to tackle the issues; (ii) bilateral business-to-business meetings, typically between one of the businesses (a buyer or service/input provider) and a set of farmers who met during the multistakeholder meetings and identified opportunities for doing business together; (iii) support to private investments on a competitive basis, through a value chain fund (VCF), for cluster smallholders and SMEs; (iv) support to quasi-public goods, through a sector development facility that addresses specific bottlenecks to the cluster development identified by the primary actors themselves, and which cannot reasonably be delivered through private investment in the current context of the specific clusters (e.g. trials, action research, testing labs, etc.); and (v) business skills for farmers, enabling them to properly assess opportunities and risks (in particular regarding climate stresses), to better negotiate their interests in VC transactions and to become reliable partners of agribusinesses. To increase access to finance and boost the appetite of financial institutions to lend to profitable agriculture sectors, the RCTP will initially pilot partnerships with one or more financial institutions that have a commercial interest in testing new approaches (e.g. alternative collateral or guarantee mechanisms along the VC clusters).

Component/outcome 2. Cluster-supportive rural infrastructure

11. To complement the above clustering ambitions, the second outcome/component will consist of cluster-supportive rural infrastructure, to remove the bottlenecks hampering consolidation and clustering of smallholders and village-based agribusiness and to promote adoption of climate-smart technologies. While contributing to increasing the profitability of the supported small farmers as agribusinesses, this component will also contribute to increasing the net income of the rural poor, who will have access to jobs created by the expansion of these agribusinesses. The outcome will be divided into two outputs/subcomponents.

12. The first will deal with investments in rural water supplies, to assist communities on a pragmatic basis, based on demand, and to support the objectives of component 1. Investments will focus on multiple-use facilities, providing households with domestic water supply, water for livestock or processing facilities and, possibly, small-scale irrigation systems. These investments will include ponds and facilities for rainwater harvesting for livestock watering, spring capping, gravity conveyance and other facilities, as will be required by site-specific conditions. They will ensure

better climate and economic resilience, as reliability of water supply and management will increase.

13. The second subcomponent will deal with investments in rural road improvement that complement and strengthen RCTP objectives under component 1, for example by assuring adequate access to RCTP-supported VC/commodity production areas and facilitating marketing of their produce. The roads to be improved will comprise mainly the last mileage of local or uncategorized roads in rural areas. Eligible investments will also include road ancillaries such as small bridges, drainage facilities and erosion protection works to ensure climate resilience of the rehabilitated roads.

Component/outcome 3. Learning and policy engagement

14. The third outcome – on documentation of evidence, learning and policy engagement – will build on the first two outcomes and will deliver outputs in the form of knowledge products, enriching the policy conversation around transformative rural pathways for poor smallholders and ensuring that the RCTP maximizes the learning opportunities available.

# III. Project implementation

## A. Approach

15. A key ambition is to promote institutional development among the core partners. The RCTP will contribute to this in several ways, including: (i) development and establishment of institutionalized systems (through clusters, business-oriented cooperatives and VC integration) for the promotion of commercial, profitable and climate-adaptive agricultural practices; and (ii) support to and expansion of public/private partnership in resilient rural infrastructure (leveraging public resources from both municipalities and central government). The outreach campaign will ensure appropriate targeting and greater synergy among the components, communicating all offers that the RCTP has available.

16. While the two primary components are highly complementary, focusing on inclusive agricultural cluster development and rural productive infrastructure upgrading, respectively, they each serve a wider purpose in support of the desired rural transformation. For example, not all developments in the clusters are primarily constrained by physical infrastructure limitations and, conversely, the planned improved infrastructure serves not only the purposes of the development of the particular product cluster but also the wider socio-economic development of the communities benefiting. Consequently, while the project will seek to develop synergy between these two components, it will not dogmatically insist on rigid linkages and force farmers to accept bundled packages of engagements. Synergy will also be sought with development partners, most notably the European Union.

## B. Organizational framework

17. The Ministry of Agriculture and Rural Development (MARD) will be the Lead Project Agency, and the RCTP will be anchored in the MARD Directorate for Rural Development . This directorate has overall responsibility for strategies and programmes in the area of rural development, including preparation of the EU-financed programmes of the Instrument for Pre-Accession Assistance for Rural Development. Anchoring the RCTP in this directorate will thus allow better coordination of development assistance, especially with the European Union.

18. Overall responsibility for RCTP oversight, political guidance and implementation will rest with a specific project steering committee (PSC), chaired by MARD. The PSC will also include representatives of all RCTP partners and stakeholders. Day-to-day management and implementation of the project will rest with a project coordination unit (PCU), which will be fully embedded and located in MARD, and vested with financial and technical autonomy. The PCU will: (i) carry out overall programming

and budgeting of RCPT activities; (ii) take the lead in implementation, in cooperation with municipalities, business development partners, infrastructure contractors, beneficiary institutions, cooperatives, etc.; and (iii) monitor and document project progress.

## C. Planning, monitoring and evaluation, and learning and knowledge management

19. A rigorous planning process will be the starting point for the sound management and monitoring of RCTP execution. It will clearly identify concrete outputs to be produced in the next 12 months in pursuit of overall objectives, activities to be implemented to deliver these outputs, and the financial resources required. While the first annual workplan and budget (AWP/B) will be prepared during the start-up workshop, the preparation of subsequent AWP/Bs will follow an iterative process, starting in about September with the organization of municipality-level annual planning workshops.

20. The monitoring and evaluation (M&E) system will be established to monitor execution and outreach punctually and reliably and to measure and evaluate results (thus monitoring design assumptions). The project will conduct: (i) a baseline survey; (ii) two qualitative surveys in years three and five; (iii) a midterm survey; and (iv) an impact survey (prior to completion). Monthly, six-monthly and annual progress reports will also be prepared.

21. Project implementation is expected to generate useful learning, which may be of value to MARD policymakers and other stakeholders. A learning and policy dialogue agenda and a KM and communication plan will be prepared within 12 months of project start-up. This will also be the platform for delivering on the ambitions of outcome three. Lessons of interest to MARD stakeholders will be identified by the KM working group and endorsed by the PSC and IFAD.

## D. Financial management, procurement and governance

22. The RCTP financial management and procurement team (finance officer, procurement officer and administrative assistant) will be part of the PCU, which, will be vested with financial and administrative autonomy. To build on MARD's capacity as much as possible, the PCU will be partly staffed with staff seconded by MARD, provided they meet all relevant qualifications. The Public Financial Management System will be used for the flow of funds from IFAD to the State Treasury and for the execution of payments. A separate financial and accounting system will be used to record and monitor project transactions.

23. The borrower will open two EUR-denominated designated accounts to receive IFAD loan and Adaptation for Smallholder Agriculture Programme (ASAP) grant resources. As fiduciary risks were assessed as low, the authorized allocation will be equal to 12 months of project expenditure based on: (i) forecasts for the first AWP/B and procurement plan; and (ii) cash forecasts for both the loan and the grant.

24. The RCTP annual external audit will be carried out by an independent audit firm acceptable to IFAD, in accordance with the International Standards on Auditing and the IFAD Guidelines for Project Audits, and based on terms of reference subject to IFAD's "no objection". The final audit report and management letter will be submitted to IFAD by the borrower at the latest six months after the end of each fiscal year. In addition, the project will submit interim, unaudited financial reports for all financing sources on a quarterly basis.

25. The procurement of goods, works and services will be conducted in accordance with IFAD Project Procurement Guidelines and the Procurement Handbook. Prior to the start of each fiscal year, the PCU will prepare a procurement plan derived from the AWP/B. The plan and AWP/B will be submitted to the PSC for approval and to IFAD for "no objection".

26. Good governance will be promoted through the involvement of municipalities and beneficiaries in: (i) preparation of the AWP/Bs; (ii) the procurement process at the community level; and (iii) monitoring and evaluation of project activities. The dissemination of IFAD's anticorruption policy among RCTP staff and stakeholders, as well as the adoption of IFAD procurement guidelines, should also reinforce the use of good practices.

## E. Supervision

27. IFAD will be responsible for direct supervision of the RCTP through supervision missions, supported by follow-up and/or specific thematic missions, as may be required, not least in the start-up phase.

# IV. Project costs, financing and benefits

## A. Project costs

28. The total cost of the RCTP, over six years, is estimated at EUR 13.61 million (including contingencies), of which 86 per cent will be for investment costs and 11 per cent for recurrent costs.

Table 1
**Project costs by component and financier**
(Thousands of euro)

| | *IFAD loan* | | *ASAP grant* | | *Other cofinanciers (SMEs)* | | *Beneficiaries* | | *Borrower/ counterpart** | | *Total* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Component* | *Amount* | *%* | *Amount* | *%* | *Amount* | *%* | *Amount* | *%* | *Amount* | *%* | *Amount* |
| 1. VC clustering for resilient rural transformation | 2 242 | 43.7 | 806 | 15.7 | 621 | 12.1 | 1 283 | 25.0 | 183 | 3.6 | 5 135 |
| 2. Cluster-supportive rural infrastructure | 913 | 12.6 | 1 074 | 14.8 | - | - | 331 | 4.6 | 4945 | 68.1 | 7 263 |
| 3. Learning and policy engagement | 722 | 59.5 | - | - | - | - | - | - | 491 | 40.5 | 1 213 |
| **Total** | **3 877** | **28.5** | **1 880** | **13.8** | **621** | **4.6** | **1 614** | **11.9** | **5 619** | **41.2** | **13 611** |

* Includes: (i) in cash contribution from the central government budget (EUR 3.07 million); (ii) taxes and duties (EUR 1.22 million); and (iii) in cash contribution from municipalities (EUR 1.33 million).

## B. Project financing

29. The IFAD loan (EUR 3.88 million,) will fund 28.5 per cent of total project costs, of which funding for components 1, 2 and 3 will comprise 43.7 per cent, 12.6 per cent and 59.5 per cent, respectively (including contingencies). The ASAP grant (EUR 1.88 million,) will finance: (i) climate-smart assistance to farmers and farmers' associations in component 1; and (ii) climate-smart infrastructure in component 2, which, in total, equals 13.8 per cent of project funding. The central government will: (a) finance taxes and duties; (b) make budget contributions (in cash) towards component 1, component 3 and mainly component 2; and (c) make in-kind contributions towards component 1. Overall contributions from the central government will amount to about EUR 4.3 million (or 31.5 per cent of the total project costs). Municipalities will contribute financing to component 2 (local investments in rural infrastructure, in cash contributions) in the amount of EUR 1.33 million (or about 9.7 per cent of the total). Some EUR 1.6 million (or 11.9 per cent of the total) will be provided by the primary beneficiaries within the project area, mainly as contributions in small-scale agriculture investments (both in cash and in kind). Local SMEs are also likely to cofinance grant funding activities in the amount of approximately 25 per cent of grant investment funding, which amounts to EUR 0.6 million (or 4.6 per cent of the total).

Table 2
**Project costs by expenditure category and financier**
(Thousands of euro)

| | *IFAD loan* | | *ASAP grant* | | *Other cofinanciers (SMEs)* | | *Beneficiaries* | | *Borrower/ counterpart* | | *Total* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Expenditure category* | *Amount* | *%* | *Amount* | *%* | *Amount* | *%* | *Amount* | *%* | *Amount* | *%* | *Amount* |
| Investment costs | | | | | | | | | | | |
| 1. Consultancies | 840 | 78.9 | 87 | 8.2 | | | 75 | 7.0 | 62 | 5.8 | 1 064 |
| 2. Works | 700 | 10.1 | 987 | 14.3 | | | 332 | 4.8 | 4 906 | 70.8 | 6 925 |
| 3. Grants and subsidies | 612 | 18.8 | 806 | 24.8 | 621 | 19.1 | 1207 | 37.3 | | | 3 246 |
| 4. Training and workshops | 530 | 96.7 | | | | | | | 18 | 3.3 | 548 |
| 5. Goods, services and inputs | 211 | 100 | | | | | | | | | 211 |
| 6. Equipment, materials and vehicles | 137 | 93.2 | | | | | | | 10 | 6.8 | 147 |
| Total investment costs | 3 030 | 25 | 1 880 | 15.5 | 621 | 5.1 | 1 614 | 13.3 | 4 996 | 41.1 | 12 141 |
| 1. Salaries and allowances | 718 | 65.0 | | | | | | | 386 | 35.0 | 1 104 |
| 2. Operating costs | 129 | 35.2 | | | | | | | 237 | 64.8 | 366 |
| Total recurrent costs | 847 | 57.6 | | | | | | | 623 | 42.4 | 1 470 |
| **Total** | **3 877** | **28.5** | **1 880** | **13.8** | **621** | **4.6** | **1 614** | **11.9** | **5 619** | **41.2** | **13 611** |

## C. Summary benefit and economic analysis

30. The benefits stream corresponds to: (i) farmer benefits analysed in the financial analysis (i.e. increased agricultural production); and (ii) economic and societal benefits analysed in the economic analysis (i.e. the economic internal rate of return). Overall project analysis suggests an economic internal rate of return of 33 per cent over 20 years and a net present value of EUR 64 million. Benefits of the project increase to EUR 168 million, and incremental costs to a little under EUR 28 million, including labour.

## D. Sustainability

31. Environmental sustainability is the key guiding principle of the RCTP, as the project will seek to leverage unique mountain-area characteristics (purity, limited/no use of pesticides, etc.) for commercial differentiation and success. All activities have been designed to enhance the capacity and incentives of private-sector agents in agriculture to sustainably increase market activity – during and after project implementation. Small-scale farmers will be equipped with knowledge, skills and opportunities for organizational infrastructure to engage in VCs, and will have access to grants for production or post-harvest equipment and/or marketing/branding to improve sales potential. Training materials will be captured and published on RCTP websites. The strong focus on profitability for both individual economic agents and groups will drive commercial sustainability and build strong incentives to maintain the structures post-project. The associations chosen to catalyse growth of the selected VCs will have a demonstrated commitment to broad-based VC development. Sustainability has also been built into the design of component 2 in several critical ways. By application of a demand-driven and cost-sharing approach, and by enhancing target group capacity for raising the productivity of existing resources, it is hoped that participants will use existing natural resources (land, pastures, water) more efficiently and profitably.

## E. Risk identification and mitigation

32. At the macro level, political risks are deemed low, as, even in the case of a change in government, the overall direction of most relevant policies (e.g. European Union accession, improving rural inclusion and adapting to climate change) is unlikely to change substantially. The more component-specific potential risks comprise, for

example: unfamiliarity with the approach to market-oriented agriculture development; smallholder reluctance to collaborate; suboptimal quality of infrastructure designs; climate risks; policy-related risks; etc.). These will be mitigated by: (i) rapid scans at project start-up to reconfirm the potential for local cluster development; (ii) credible and affordable investment pathways for smallholders to participate in the selected cluster (through establishment of different windows for accessing matching grants); (iii) dialogue with and engagement of farmers in multistakeholder meetings; (iv) intensive and sustained technical assistance, especially during the first three years; (v) empowerment of the targeted communities in decision-making; (vi) a preliminary study on water balances of microcatchments to pre-identify wider areas for piloting rainwater harvesting; and (vii) a strong KM/policy engagement agenda, aimed at bringing proven successful models and approaches to the Government.

# V. Corporate considerations

## A. Compliance with IFAD policies

33. The RCTP is fully aligned with the IFAD Strategic Framework 2016-2025 and will contribute to all of its objectives. The project is also aligned with the strategic objectives of the Country Strategy Note approved in May 2016. Through the catalytic support of the ASAP grant, climate resilience is strongly built into the project, contributing to the 100 per cent climate resilience target for IFAD10. In terms of environmental impact, the RCTP is classified in category B. The project will also comply with the IFAD private-sector strategy, promoting commercial partnerships between SMEs, smallholder farmers and agribusinesses. Finally, the RCTP design has been conducted in full accord with IFAD’s targeting policy.

## B. Alignment and harmonization

34. The RCTP will be aligned with and contribute to: (i) the government Economy Reform Programme, which promotes a regionally and socio-economically balanced development process; and (ii) the national strategy for the Development of Agriculture and Rural Areas 2015-2020, which promotes climate change adaptation, natural resource management and sustainable smallholder agriculture. The RCTP will also complement European Union programmes, reinforcing MARD’s strategy of helping smallholders progressively graduate to meeting European Union standards. To facilitate this, the RCPT will adopt a dynamic approach to semi-commercial agriculture, which builds the resilience of smallholders and raises returns to existing farm assets, but at the same time integrates such interventions into other engagements to promote growth, jobs and increased incomes in the rural non-farm economy.

## C. Innovations and scaling up

35. Through private and quasi-public investment incentives (e.g. with matching grants and the sector development facility), the RCTP will promote investment in innovations in the local clusters (new climate-smart technologies, varieties, etc.) that are expected to be replicable by others (using mainstream financing), once their commercial success has been demonstrated. The project will also promote innovations in climate-resilient rural infrastructure.

36. With, probably, a limited time frame for IFAD engagement, it will be important that RCTP interventions are quickly scalable, without needing long-term support from IFAD. Knowledge capture – and its use to leverage additional financial resources and inform policy shifts in favour of smallholders – will be the main scaling up pathway. Proven successful results will be used by the Government to leverage partnerships with the European Union and the private sector to expand outreach to more smallholder farmers. There will be two dimensions to the RCTP scaling-up approach. The first will be to promote scaling up of new production and infrastructure technologies and operational approaches/models that the project has

shown to be relevant, effective and efficient. A strong focus on innovation, knowledge capture/dissemination and policy engagement will offer the Government the opportunity to draw on implementation experience in developing its own policies, strategies and investments for smallholder agricultural development, including by simply replicating the concepts more widely. Second, the RCTP will strengthen the capacity of the diverse VC players, and assist them in building sustainable business relations that can subsequently be scaled up.

## D. Policy engagement

37. The RCTP is designed to reflect and conform to national policies. In addition, however, it is expected to: (i) pilot new approaches to smallholder-focused rural development and draw out lessons that can potentially inform new national policies and strategies; (ii) create space for engagement and dialogue involving key players in the selected VCs, which in turn can identify specific policy bottlenecks that constrain the development of those VCs; and (iii) on the basis of the issues emerging under (i) and (ii) above, conduct more-specific policy reviews/analyses as necessary. Implementation is expected to generate useful lessons in a number of key thematic areas, which may be of value to MARD policymakers and other stakeholders. For certain more-complex policy issues, project lessons and experience may need to be complemented with more in-depth policy studies/analysis. During implementation, the initial learning and policy dialogue agenda will be enriched with new policy issues emerging from the established clusters. Documentation of key, evidenced-based lessons will include a range of methods, while their dissemination will depend on the targeted audience.

# VI. Legal instruments and authority

38. A project financing agreement between Montenegro and IFAD will constitute the legal instrument for extending the proposed financing to the borrower. A copy of the negotiated financing agreement is attached as appendix I.

39. Montenegro is empowered under its laws to receive financing from IFAD.

40. I am satisfied that the proposed financing will comply with the Agreement Establishing IFAD and the Policies and Criteria for IFAD Financing.

# VII. Recommendation

41. I recommend that the Executive Board approve the proposed financing in terms of the following resolution:

> RESOLVED: that the Fund shall provide a loan on ordinary terms to Montenegro in an amount of three million eight hundred eighty thousand euro (EUR 3,880,000), and upon such terms and conditions as shall be substantially in accordance with the terms and conditions presented herein.
>
> RESOLVED FURTHER: that the Fund shall provide an ASAP grant to Montenegro in an amount of one million eight hundred eighty thousand euro (EUR 1,880,000), and upon such terms and conditions as shall be substantially in accordance with the terms and conditions presented herein.

Gilbert F. Houngbo
President

# Negotiated financing agreement

## Negotiated financing agreement: "Rural Clustering and Transformation Project"

(Negotiations concluded on 7 March 2017)

Loan Number: ________
Grant Number: _______

Project Title: Rural Clustering and Transformation Project (the "RCTP" or "the Project")

Montenegro (the "Borrower/Recipient")

and

The International Fund for Agricultural Development (the "Fund" or "IFAD")

(each a "Party" and both of them collectively the "Parties")

HEREBY agree as follows:

Section A

1. The following documents collectively form this Agreement: this document, the Project Description and Implementation Arrangements (Schedule 1) and the Allocation Table (Schedule 2).

2. The Fund's General Conditions for Agricultural Development Financing dated 29 April 2009, amended as of April 2014, and as may be amended hereafter from time to time (the "General Conditions") are annexed to this Agreement, and all provisions thereof shall apply to this Agreement, For the purposes of this Agreement the terms defined in the General Conditions shall have the meanings set forth therein.

3. The Fund shall provide a Loan and a Grant to the Borrower/Recipient (the "Financing"), which the Borrower/Recipient shall use to implement the Project in accordance with the terms and conditions of this Agreement.

Section B

1. A. The amount of the Loan is three million eight hundred eighty thousand euros (EUR 3 880 000).

   B. The amount of the Grant is one million eight hundred eighty thousand euros (EUR 1 880 000).

2. The Loan is granted on ordinary terms, and shall be subject to interest on the principal amount of the Loan outstanding at a rate equal to the IFAD Reference Interest Rate, payable semiannually in the Loan Service Payment Currency, and shall have a maturity period of fifteen (15) years, including a grace period of three (3) years starting from the date that the Fund has determined that all general conditions precedent to

withdrawal have been fulfilled in accordance with Section 4.02(b) of the General Conditions.

3. The Loan Service Payment Currency shall be the Euro.

4. The first day of the applicable Fiscal Year shall be 1 January.

5. Payments of principal and interest shall be payable on each 15 May and 15 November.

6. The Borrower/Recipient shall provide counterpart financing for the Project in the amount of five million six hundred twenty thousand Euros (EUR 5 620 000) (Central Government, Local Municipalities).

## Section C

1. The Lead Project Agency shall be the Ministry of Agriculture and Rural Development (MARD).

2. The following are designated as additional Project Parties: Local municipalities, SMEs, Farmers and farmers' organizations (FOs).

3. The Project Completion Date shall be the sixth anniversary of the date of entry into force of this Agreement.

## Section D

1. The Financing will be administered and the Project supervised by the Fund.

## Section E

1. The following are designated as additional general conditions precedent to withdrawal:

(a) the Project dedicated and key staff – whether to be recruited or to be seconded from MARD – is in place (Coordinator, 2 Value Chain Experts, Monitoring and Evaluation (M&E) Officer, Finance Officer, Procurement Officer and Administrative Assistant);

(b) two designated accounts have been opened to receive resources from the Loan and Grant accounts;

(c) acquisition and configuration of financial, accounting and operational software to support all the transactions, budget and cash forecasts analysis, operational and financial dashboards; and

(d) preparation of a draft Project Implementation Manual acceptable to IFAD, including financial, accounting, procurement and administrative arrangements.

2. The following are the designated representatives and addresses to be used for any communication related to this Agreement:

For the Borrower/Recipient:

Minister of Finance
Ministry of Finance
Stanka Dragojevica st 2
81000 Podgorica
Montenegro

For the Fund:

The President
International Fund for Agricultural Development
Via Paolo di Dono 44
00142 Rome, Italy

This Agreement, dated _____________, has been prepared in the English language in two (2) original copies, one (1) for the Fund and one (1) for the Borrower/Recipient.

MONTENEGRO

____________________
(Authorized Representative)
(title)

INTERNATIONAL FUND FOR
AGRICULTURAL DEVELOPMENT

___________________
Kanayo F. Nwanze
President

# Schedule 1

## Project Description and Implementation Arrangements

## I. Project Description

1. Project Area. The project will focus on rural areas in the northern mountainous region, where farm land is mostly above 600 meters altitude. Selection criteria are based on socio-economic, poverty, and climate vulnerability profiles, coupled with potential for enterprise development in the products pre-identified (see Component 1) and the target groups' willingness to participate in the project. The initial selection includes Niksic, Savnik, Zabljak, Berane, Mojkovac, Petnjica, and Bijelo Polje. At a later stage Pluzine, and Andrijevica, may be included, pending funding, market opportunities and potential impact on smallholders.

2. Target Population. The project target groups will be:

- The semi-subsistence farmers/households below the threshold for agro-budget (government) and EU subventions, who have access to small areas of farm/arable land (up to 2 ha), grow some fruits/vegetables and keep some livestock.
- The commercial and economically active smallholders and small-scale processors, who typically own 2-15 ha of arable land, 10-15 cows, 50-100 sheep and goats, or orchards.
- The strategic value chain (VCs) actors, who include larger, lead farmers and agro-enterprises, traders, private service providers, cooperatives or associations, who can serve as models to demonstrate the viability of new approaches to increase rural resilience and provide potential development pathways for the poor.

3. Not all beneficiaries, however, will derive the same types of benefits, and depth of outreach will vary. Thus, beneficiaries may be categorized as follows:

- The primary beneficiaries (households expected to benefit the most from the project) are the key actors in the supported VC, who will receive a matching grant from the value chain fund to invest in a profitable activity and who will be supported to establish business and trade agreements. Within this group, the active smallholders and poorer farmers will benefit the most.
- The secondary beneficiaries are all the producers, suppliers, traders or agri-businesses who will not receive a VCF grant or Business Skill Facilitation (BSF) training, but who will participate in cluster meetings and, gradually, in cluster activities. The improved production and market conditions will stimulate their motivation to join the VC activities with their own investments, ultimately resulting in improved incomes.
- The tertiary beneficiaries are the households who will benefit from the improved roads and the new water supply schemes, but who will not receive other support from the project and will not engage in RCTP supported VC activities. They will essentially benefit from improved resilience to climate change and from a more modest increase in incomes, compared with the previous two categories, due to the reduction of transportation costs and water shortages resulting in better agricultural productivity.

4. Goal. The goal of the Project is to contribute to the transformation of smallholders' livelihoods in northern Montenegro, enabling them to become more competitive and resilient to climate change.

5. Objective. The Project development objective aims at increasing the participation of poor smallholders in inclusive, profitable and environmentally sustainable VCs, and enhance the benefits they derive from them.

6. Components. The Project will have two core components that envisage a number of complementarities between activities and subcomponents.

6.1. Component 1: VC clustering for resilient rural transformation. This component will focus on promoting the expansion of competitive clusters for a portfolio of products with confirmed market potential and comparative advantages for smallholder production. The clusters will be geographic concentration of interconnected producers, businesses, suppliers, and associated institutions, which creates synergies among them, resulting in market linkages. Three clusters have been initially identified: livestock (primarily sheep/goat meat but also high-value dairy), cultivated berries and seed potatoes, with possible later expansion of the product range and geographical coverage. The component will develop the following main activities:

6.1.1. Multi-stakeholder cluster meetings, where the actors will discuss challenges and opportunities and develop an action plan together to tackle the issues.

6.1.2. Bilateral business-to-business meetings, between one of the businesses and farmers who met during the multi-stakeholder meetings and identified opportunities to do business together.

6.1.3. Support to private investments on a competitive basis through a value chain fund (VCF), for smallholders and SMEs engaged in the clusters.

6.1.4. Support to quasi-public goods, through a sector development facility (SDF), that address bottlenecks to the cluster development identified by the primary actors and which cannot reasonably be delivered through private investment in the current context of the specific clusters.

6.1.5. Business skills for farmers, enabling them to assess opportunities and risks, to better negotiate their interests in VC transactions and to become reliable partners to agri-businesses.

6.1.6. Pilot partnerships with financial institution(s) which have a commercial interest in testing new approaches (e.g. alternative collateral or guarantee mechanisms along the clusters) to increase access to finance and to boost the appetite to lend to profitable agricultural sectors.

6.2. Component 2: Cluster supportive rural infrastructure. To complement the above clustering ambitions, the second component will consist of cluster supportive rural infrastructure, to remove the bottlenecks hampering the consolidation and clustering of smallholders and village based agri-business and to promote the adoption of climate smart technologies. The component will operate under two sub-components:

6.2.1. Investments in rural water supplies, to assist communities on a pragmatic basis, based on demand, and in support of the objectives of Component 1. The investments will focus on multiple use facilities, providing households with domestic water supply, water to cater for livestock or processing facilities, and possibly small scale irrigation systems. All investments will ensure better climate and economic resilience as reliability of water supply and management will increase.

6.2.2. Investments in rural roads improvement, that complement the project's objectives under Component 1 by assuring adequate access to RCTP-supported VC/commodity production areas and facilitating marketing of their produce. The roads to be improved will comprise mainly of last mileage of local or uncategorised roads in rural areas. Eligible investments will include also road ancillaries such as small bridges, drainage facilities and erosion protection works to ensure climate resilience of the rehabilitated roads.

## I. Implementation Arrangements

7. The Lead Project Agency: The Ministry of Agriculture and Rural Development (MARD) shall be responsible for implementation of the Project. The Project will be anchored to the Directorate for Rural Development Department of the MARD. Overall responsibility for Project oversight, political guidance and implementation will rest with a specific project steering committee (PSC), established and chaired by MARD. The PSC will also include representatives from all of the Project's partners and stakeholders (i.e. the Ministry of Finance, Ministry of Sustainable Development and Tourism, Ministry of Economy, representatives of partner municipalities, and the private sector, including farmers' organisations). The PSC membership may be amended depending on Project requirements, subject to prior approval of IFAD. Day-to-day management and implementation of the project will rest with a Project Coordination Unit (PCU), which will be fully embedded and located in MARD and vested with financial and technical autonomy. The PCU will (i) carry out the overall programming and budgeting of the RCTP activities; (ii) take the lead in implementation, in cooperation with municipalities, business development partners, infrastructure contractors, beneficiary institutions, cooperatives, etc.; and (iii) monitor and document project progress. Project procurement shall be carried out in accordance with IFAD's Project Procurement Guidelines.

8. Implementation arrangements for Component 1. The PCU will work closely with the MARD regional extension services to coordinate and deliver all activities under cluster development and facilitation. The PCU will act as the fund administrator for the VCF but with an Independent Investment Committee established to make grant award decisions. The PCU will ensure compliance with grant application, eligibility, award and implementation procedures set-out in the Project Implementation Manual (PIM).

9. Implementation arrangements for Component 2. The main tasks of the PCU will be conducting information campaign in the project area municipalities, technical and financial analysis of preliminary screened infrastructure proposals, review and approval of engineering designs provided by municipalities, procurement and supervision of civil works. Provisions will also be made for feasibility study and financial and economic analysis of proposed investments to be outsourced to private sector consultant on a short term basis during the selection phases of proposals.

10. Baseline survey. The conduct of a baseline survey is a critical and mandatory exercise, to be carried out at the earliest after project start. Its objective is to describe and document the socio-economic and livelihoods conditions of the potential RCTP beneficiaries prior to project interventions. This information will, at mid-term and completion, become the reference against which to measure changes, and appreciate project outcomes and impact, or lack thereof. The PCU can outsource this survey to a competent consultancy firm or service provider.

11. Mid-term review (MTR). A MTR shall be carried out by the Borrower/Recipient and IFAD jointly towards the end of Project Year 3. It shall assess, among other things, management performance, implementation status, outreach, targeting, and progress towards achievement of development objective. It also focuses on corrective actions to address performance gaps and other issues.

12. Impact survey. An overall impact assessment shall be carried out during the last year of implementation, before the Project Completion Date. The PCU can outsource this survey to a competent consultancy firm or service provider.

13. Project Completion Review (PCR). Jointly organized by the government and IFAD, it shall be held towards the end of the Project Implementation Period, ideally before the Project Completion Date, once the impact survey is available, but no later than 3 months after project closing. The PCR will focus on assessing the relevance of Project interventions, implementation effectiveness and efficiency, outreach and targeting, the

likelihood of sustainability of project benefits and the potential for upscaling and replication. The PCR also aims at generating and documenting useful lessons from implementation that will help improve future programming or policies.

14. Project Implementation Manual (PIM). The PCU shall finalize the PIM (drafted in Appendix 11 of the PDR) and submit it for approval to the PSC and IFAD. The PIM may be amended when necessary, with prior no-objection from IFAD, to introduce clarification in procedures, eliminating constraints for project implementation and for facilitating access of producers to the project services.

## Schedule 2

### Allocation Table

1. Allocation of Proceeds. The Table below sets forth the Categories of Eligible Expenditures to be financed by the a Loan and a Grant and the allocation of the amounts of the a Loan and a Grant to each Category and the percentages of expenditures for items to be financed in each Category. All amounts are 100% net of taxes and the contributions of co-financiers.

| Category | Loan Amount Allocated (EUR) | ASAP Grant Amount Allocated EUR) |
|---|---|---|
| 1. Consultancies | 800 000 | 85 000 |
| 2. Works | 665 000 | 940 000 |
| 3. Grants | 580 000 | 765 000 |
| 4. Training and Workshops | 505 000 | |
| 5. Goods, services and inputs | 200 000 | |
| 6. Equipment, materials and vehicles | 130 000 | |
| 7. Recurrent costs | 805 000 | |
| Unallocated | 195 000 | 90 000 |
| TOTAL | 3 880 000 | 1 880 000 |

2. Start-up Costs. Withdrawals in respect of expenditures for start-up costs incurred before the satisfaction of the general conditions precedent to withdrawal shall not exceed an aggregate amount of EUR 150 000.

# Logical framework

| Results | Indicators and targets | | | | Means of Verification | | | Assumptions |
|---|---|---|---|---|---|---|---|---|
| | Indicators | Baseline | MT | End (Y6) | Source | Freq. | Resp. | |
| **Overall goal:** To contribute to the transformation of smallholders' livelihoods in northern Montenegro, enabling them to become commercially competitive and more resilient to climate change. | 1. Percentage decrease in rural poverty in supported municipalities compared to national rural poverty rate | n/a | n/a | 10% | Project impact survey<br>Municipality statistics | At completion | M&E Officer | Initial and continued political commitment and support to project implementation.<br>Macro-economic conditions remain stable or improve. |
| **Development Objective**: To increase the participation of poor smallholders in inclusive, profitable and environmentally sustainable value chains, and enhance the benefits they derive from them. | 2. Number of participating households registering an increase in income of at least 30% | n/a | 500 | 2400 | Project impact survey<br>BSF records<br>Farmers' diaries | At completion | M&E Officer | |
| ***Outcome 1:*** *Improved commercial relations between smallholders, suppliers and buyers – supported by relevant public actors; and increased level of investments in the selected value chain.* | 3. Number of VC smallholders involved in the production of selected commodities | n/a | 1500 | 3000 | Farmers' diaries<br>BSF records<br>Project outcome surveys<br>Farmers' diaries | Annually, starting Y2 | - VC Specialists<br>- M&E Officer | Macro-economic conditions continue to be supportive for doing business.<br>Smallholders' and VC actors' willingness to participate in selected value chains.<br>VC suppliers' ability to respond to technical support requests by smallholders.<br>Marketing potential for berries remains high. |
| | 4. Percentage increase in the value of marketed commodities, by VC | n/a | 20% | 50% | | Annually, starting Y 3 | - VC Specialists<br>- M&E Officer | |
| | 5. Value of incremental investments in selected VCs (excluding project financing) | n/a | €0.5m | €2m | BSF records<br>Project sector study | At mid-term and completion | - VC Specialists<br>- M&E Officer | |
| ***Outcome 2:*** *Enhanced resilience of smallholders' livelihoods to climate change through improved access to water supply systems and all-weather farm gate roads.* | 6. Number of households with improved access to climate resilient roads and water supply systems (RIMS) (ASAP)[1] | 0 | 800 | 2000 | Contractors' records<br>Municipal staff records | Annually | - PCU Engineer<br>- M&E Officer | Climate change patterns are according to current predictions.<br>Continued fiscal space for GoM and municipalities to pay their contributions.<br>No political interference in the choice of investments. |
| ***Outcome 3*** *– Lessons from project approaches and implementation are incorporated into national or municipal-level policies, strategies or investments.* | 7. Number of policies, strategies and investments influenced by project experience | n/a | At least 1 | At least 3 | Amended policy or project documents | Annually, after mid-term | M&E Officer | Continuing MARD's interest to support poor smallholders.<br>Policy makers' willingness to learn from project experience |
| **Outputs:** | | | | | | | | |
| Multi-stakeholder clusters established and facilitated for four commodities*; and business or trading plans agreed between smallholders and suppliers/buyers. | 8. Number of functional clusters (A) | 6 | 7 | 11 | VC Specialists records<br>Cluster meeting minutes | Annually | VC Specialists | |

[1] In the context of the RCTP, the main vulnerabilities of smallholders to climate change are all-weather access to market and to sustainable water resources. Thus this indicator will reflect the number of households for which climate resilience has increased.

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 9. Percentage of participating VC smallholders with an agreed business or trading plan* | 0 | 80% | 100% | BSF records | Six-monthly | BSF | |
| Strategic investment grants provided to value chain actors and for "quasi-public" goods. | 10. Number of VCF grant recipients* | 20 | At least 300 | At least 500 | VCF manager records<br>Minutes of VCF board meetings | Monthly | VCF Manager | |
| | 11. Percentage of grant recipients meeting their first key performance criteria as defined in grant contracts* | 80% | 80% | 80% | VCF Manager records | Six-monthly | VCF Manager | |
| Project implementers, key Government stakeholders and smallholders provided with capacity development support. | 12. Number of project implementers and Government staff trained in value chain and cluster development* | 20 | 20 | 40 | PCU training records | Annually | M&E Officer | |
| | 13. Number of smallholders trained in business development* (RIMS) | 0 | 1500 | 2500 | BSF training records | Annually | BSF | |
| Rain-harvesting water structures and other water supply systems constructed or rehabilitated. | 14. Number of water supply schemes newly constructed or rehabilitated | 0 | 11 | 27 | Contractors' activity reports<br>Municipal Engineers' records | Monthly, starting from contract award date | PCU Engineer | |
| "Last km" farm roads rehabilitated or upgraded according to best standards. | 15. Number of km of roads rehabilitated or upgraded (RIMS) | 0 | 26 | 70 | | | | |
| Relevant knowledge products prepared and disseminated to key stakeholders. | 16. Number of knowledge products produced and disseminated (RIMS) | 0 | At least 2 | At least 5 | – PCU records<br>– PSC minutes<br>– KM working group minutes | Annually | M&E Officer | |