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FROM: Vice President and Secretary

June 27, 2000

**TRANSITIONAL SUPPORT STRATEGY FOR KOSOVO
PROGRESS REPORT**

Attached is a Memorandum from the President entitled "Transitional Support Strategy for Kosovo – Progress Report" dated June 23, 2000.

Questions on the Progress Report may be addressed to Mr. Poortman (ext. 33011) and Mr. Horvai (ext. 33046).

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Memorandum to the Executive Directors of IBRD and IDA

Transitional Support Strategy for Kosovo Progress Report

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ABBREVIATIONS AND ACRONYMS

EC	European Commission
EC TAFKO	European Commission Task Force for the Reconstruction of Kosovo
EU	European Union
EUAR	European Agency for Reconstruction
FAO	Food and Agriculture Organization
FRY	Federal Republic of Yugoslavia (Serbia and Montenegro)
FYROM	former Yugoslav Republic of Macedonia
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IMF	International Monetary Fund
JIAS	Joint Interim Administrative Structure
KFOR	Kosovo Force
KTC	Kosovo Transitional Council
MIGA	Multilateral Investment Guarantee Agency
MEB	Micro Enterprise Bank
NGO	Non-governmental organization
SEE	Southeast Europe
SME	Small and medium enterprise
TFK	Trust Fund for Kosovo
TSS	Transitional Support Strategy
UN	United Nations
UNHCR	United Nations High Commissioner for Refugees
UNMIK	United Nations Mission in Kosovo

Transitional Support Strategy for Kosovo¹ Progress Report

I. Introduction

1. The United Nations (UN) Security Council Resolution of June 1999, which embodied the principles for a political solution of the Kosovo crisis, called for a coordinated international effort to support Kosovo's post-conflict reconstruction and recovery.² In response to this request, in October 1999, the Board of Executive Directors endorsed the Transitional Support Strategy (TSS) and the establishment of the Trust Fund for Kosovo (TFK) to support its implementation.³ A first tranche of \$25 million was allocated to the TFK from IBRD's FY99 net income to be provided on a grant basis.⁴ The TSS envisaged that a second tranche on the order of \$25-35 million from FY00 net income would be proposed, subject to availability of IBRD net income, in the context of a Progress Report after about nine months of implementation of the TSS. This report takes stock of the implementation of the TSS and recommends the allocation of \$35 million from IBRD FY00 net income to the TFK for the continuation of our program in Kosovo.

II. Background

2. **Political developments.** On the basis of the UN Security Council Resolution 1244, the Secretary General established the UN Interim Administration in Kosovo (UNMIK) as the transitional administration which is to be replaced over time with provisional self-governing local institutions, and by more permanent arrangements under an eventual political settlement for the province. In order to prepare for the first phase of self-governance, a Kosovo Transitional Council (KTC), Kosovo's highest political consultative body, was created to include representatives from Kosovo's Albanian, Serb and other ethnic groups from the start. UNMIK made further important progress in the first months of 2000 by abolishing the parallel political structures, and broadening local participation in Kosovo's governing institutions through the establishment of a Joint Interim Administrative Structure (JIAS). Under the JIAS, 20 departments (akin to ministries) are being established, each of them jointly led by an international and a Kosovar co-head. Although the KTC and the JIAS have wielded both policy making and implementation powers, the supreme authority in Kosovo remains the Special Representative of the UN Secretary General.

¹ Kosovo, Federal Republic of Yugoslavia (Serbia and Montenegro), hereinafter Kosovo.

² UN Security Council Resolution 1244, June 10, 1999.

³ Transitional Support Strategy for Kosovo (R99-178), September 16, 1999 and Resolutions No. 99-7 and No. IDA 99-4.

⁴ Board of Governors' Resolution No. 529, adopted on September 30, 1999.

3. Except for the shared vision of an independent Kosovo, political division remains strong in the Kosovar Albanian community. The Kosovar Serbs are also divided, and there is no dialogue between the Kosovar Albanian and Serb political leaders, except in the UNMIK- provided framework. Municipal elections are expected to take place during the fall which will provide a first indication of the popular support of the current political parties, and will represent an important step towards the establishment of representative governance.

4. While the Stability Pact for Southeast Europe has added an important impetus to regional cooperation, stability in the region remains fragile. Furthermore, there has not been progress in agreeing on the final political settlement for Kosovo, and given the political situation in FRY, it remains unclear when this might happen.

5. *Security situation.* Despite the heavy military presence of KFOR, the security situation remains tense. Ethnically motivated violence occurs on a daily basis and the understaffed police force is often unable to cope with its task. Notwithstanding UNMIK's repeated calls for more international police staff, there is an insufficient number of international police and training of the local police, while started, takes time. The local court and enforcement systems are severely deficient in handling their responsibilities. UNMIK has been making every effort to remedy this situation by strengthening the police and reinforcing the judiciary system.

6. *State of the economy.* The economic consequences of the Spring 1999 conflict were severe. Industrial output collapsed and agriculture production plummeted, while livestock herds were lost or killed and the planting season missed. Actual conflict-related damage is concentrated on private housing – both urban and rural, in particular in the western part of Kosovo – agriculture, and some infrastructure.⁵ Among the most significant impacts of the conflict was the massive flight of people from their homes and the dislocation this caused (Box 1). The conflict followed on the heels of ten years of economic neglect, rapidly declining incomes and increasing discrimination against the Kosovar Albanian population.

Box 1. Displacement of the Population During and After the Conflict

Of Kosovo's estimated pre-conflict population of 2.2 million (82-90 percent ethnic Albanian), it is estimated that over 800,000 Kosovar Albanians fled to neighboring Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia (FYROM), and other parts of FRY, plus tens of thousands to other countries during the course of the conflict. More than half a million were internally displaced and over 10,000 killed. While by August last year most Kosovar Albanian refugees had returned, the post-conflict period has seen a massive exodus of Kosovar Serbs. It is estimated that the pre-conflict population of Kosovar Serbs has been reduced from nearly a quarter of a million to below 70,000 while that of the Roma from 150,000 to only 30,000.

⁵ Estimates of expenditures required to address conflict-related damage and the effects of prolonged lack of maintenance of the capital stock and of infrastructure are contained in a joint EC-World Bank report, *Toward Stability and Prosperity: A Program for Reconstruction and Recovery in Kosovo*, November 3, 1999 (para. 12).

7. The Kosovar economy appears to have made a strong start in recovering from the contraction in output per head over the past two decades and then the ravages of the conflict. No official statistics of output or investment exist, but the repair of housing, the tilling of farmland, burgeoning services in urban areas, and even the revival of some enterprises provide testament to the industry of the population and its determination to make up for the lost time. These developments reflect not only the impact of donor assistance but also reliance on domestic savings and inflows of diaspora funds for investment, as well as a sturdy belief in self-effort. Furthermore, the heavy international presence creates jobs and incomes for many, in particular in the urban areas. Nevertheless, it is clear that conflict-related damage, the poor state of infrastructure, inadequate energy supplies, the denuded capital stock in enterprises and the complete lack of a financial intermediation system are powerful factors constraining growth.

8. *The international humanitarian and reconstruction effort.* Following the end of the conflict, the highest priority was to ensure that the population, including the refugees who returned to Kosovo in much greater number and much shorter time than expected, would be protected during the winter. In particular, the provision of food and shelter was critical, and UNHCR, with the help of many international and local NGOs, was effective in preparing the population for the winter. In addition, the Kosovars did not wait for international assistance but started to rebuild their homes and took the initiative to help themselves. The second highest priority was the initiation of a reconstruction and economic recovery program based on a needs assessment and mobilization of donor resources for its implementation. The Bank has played an important role in these areas as described in para. 12. Soon after the conflict, emergency reconstruction activities started, thanks, in large part, to the efforts of EC's TAFKO⁶ and some key bilateral donors.

III. Major Challenges in Kosovo

9. The Kosovo Reconstruction and Recovery Program prepared by the Bank and the EC last November, and UNMIK's recently issued reconstruction investment program for 2000⁷, identify three main challenges for Kosovo:

- To develop a thriving, open and transparent market economy, which can quickly provide jobs to a large part of the Kosovar population; this requires restarting the rural economy, encouraging the development of the private sector, and addressing the issues of public enterprises;
- To restart public administration and establish transparent, effective and sustainable institutions, with particular focus on setting up the central institutions that are key for economic recovery, developing municipal governance, and restoring law and order through an effective police and judiciary; and
- To mitigate the impact of the conflict and to start addressing the legacy of the 1990s, with a focus on restoring adequate living conditions (and in particular housing repair, local infrastructure rehabilitation, and landmine clearance), rehabilitating the

⁶ The European Commission's Task Force for the Reconstruction of Kosovo.

⁷ Kosovo: Reconstruction 2000. UNMIK Department of Reconstruction. April 2000.

infrastructure networks needed for economic development (telecommunications, energy, transport), and upgrading social service delivery (both education and health).

10. Much has been already accomplished by UNMIK in all three areas since the end of the conflict. In particular, UNMIK has created the basic foundations of macroeconomic management to ensure macroeconomic stability and conditions for the revival of economic activity. UNMIK has adopted realistic budgets for the remaining months of 1999 and the year 2000, established a treasury (the Central Fiscal Authority) with proper controls over expenditures, permitted the unfettered use of the deutsche mark in all transactions to shield Kosovo from inflation, adjusted the highly distorted trade regime, established customs and tax administration to begin to collect local revenues for the budget, and created a fully functioning bank licensing and supervision capability (the Banking and Payments Authority). It has also developed a reconstruction investment program for 2000 to set priorities for donor interventions, and has played an important role in donor coordination. Finally, it has started to focus on the medium-term reform agenda, including issues of private sector development, privatization and social protection. Nevertheless, the past one year since the end of the conflict represents just the beginning of a medium-term process.

IV. Implementation of the Transitional Support Strategy

11. In view of the limited availability of non-regular financial resources to support the implementation of our assistance strategy in Kosovo, and in light of the large financing role of other donors, such as the European Union (EU), our strategy has been limited in scope. It has aimed at helping to ensure the overall sustainability of the reconstruction and recovery effort by using the Bank's comparative advantage in aid coordination and policy advice, and through selective financial support.

12. *Aid coordination.* The Bank together with the EC took the lead, in partnership with many other agencies, to prepare an initial reconstruction and recovery program with an external financing requirement of about \$2.3 billion for a period of 4-5 years. Two donors' conferences were co-chaired by the Bank and the EC last year to mobilize resources for activities in support of reconstruction and recovery as well as for urgent budget needs, securing \$1.4 billion in donor pledges for this purpose. As co-chair of the High Level and Working Level Steering Groups for Southeast Europe, with the support of the Bank/EC joint office in Brussels, the Bank has been monitoring the implementation of this program, and in particular the evolution of donor flows.

13. *Policy and technical advice.* Economic policy advice to UNMIK, in close collaboration with the IMF, has been an important part of our assistance. The Bank's advice has been sought in almost all areas of economic management, including fiscal management, trade, banking, and private sector development. The Bank prepared an initial economic assessment for the Donors' Conference last fall⁸, and a full economic report which will be widely discussed in Kosovo over the coming weeks. A social

⁸ Kosovo: Building Peace Through Sustained Growth, The Economic and Social Policy Agenda, November 3, 1999.

assessment has also been prepared to identify the key social and institutional constraints and opportunities relevant to sustainable socio-economic development in Kosovo.

14. **Limited financial assistance.** Using *Post-Conflict Fund* resources (\$2 million), we have been able to provide urgently needed support for recurrent costs in the health and education sector, principally for salaries of teachers and health workers, and to set up a pilot community development fund that provides grants to communities, with high incidence of poverty and conflict-related damage, for priority investments on a locally determined basis (Box 2).

Box 2. The Community Development Fund

The Community Development Fund (CF) was established in November 1999 with \$1 million funding from the Post-Conflict Fund and \$1.2 million cofinancing by the Swiss Government. An additional \$6 million cofinancing has been recently approved by the Dutch Government. The CF operates under the auspices of the Kosovo Fund for Open Society and is an entirely local institution with a professional staff of 11 and a local board of directors, including representatives of minorities. It supports small-scale infrastructure and social services projects at the village or neighborhood level, and operates in a demand-driven manner with a strong emphasis on community participation in development, financing, contracting, supervision and sustaining the impact of investments. In Kosovo, the CF can draw on the strong tradition of self-help and cohesion that exists in many communities.

The CF targets communities based on indicators of both poverty and conflict-related damage. Most of its efforts are focused on rural communities, which fall outside the reach of many municipal services and which experienced heavier fighting. Twenty percent of the funding is set aside for minorities and extremely vulnerable groups outside the target municipalities.

The CF requires that communities finance at least 15% of the value of the projects and conducts a thorough screening process that examines the financial, technical, institutional, social and environmental aspects. The project has taken off in Kosovo – four pilot projects are now being contracted; a total of 58 applications have been submitted to the CF to date. Rural roads have been a key priority for isolated villages struggling to rebuild and revitalize local activity. There has also been strong demand for water supply, sanitation and irrigation for villages, as well as for school rehabilitation.

15. In selecting activities to be financed from the *Trust Fund for Kosovo*, we have focused initially on two major areas: (i) supporting the creation of institutions and policies for basic macroeconomic management, with a view to enhancing fiscal sustainability, and (ii) supporting economic restart.

- The *Economic Assistance Grant* (\$5 million) supported two elements of UNMIK's economic program: (i) the creation of a fully functioning and effective budget management system within the interim government of Kosovo, with modern standards of public expenditure management, transparent fiscal operations and accounting and audit; and (ii) the establishment of a fully functioning and effective bank licensing and supervision capability with a view to stimulating banking activities in a safe and sound manner. This grant provided much needed fiscal support to UNMIK within an agreed budget framework and appropriate burden sharing with other donors.
- This operation has been accompanied by the *Education and Health Project* (\$4.4 million) with the objective of improving the efficiency and equity of public resources allocation for education and health services. The project, which is implemented by UNMIK, supports (i) the design and piloting of an education funding system; (ii) strengthening of the University of Pristina; (iii) developing a capacity to define

standards and assess student performance; (iv) developing education governance and management structures; (v) developing a health strategy and an implementation plan for restructuring the health sector; (vi) strengthening the capacity of the health insurance fund; (vii) developing a social protection strategy and strengthening the capacity of local social protection institutions; and (viii) monitoring the impact of social sector reforms.

16. In order to help the revitalization of economic activity and thus generation of employment and income, we have designed an operation in agriculture and a line of credit for small and medium size enterprises (SMEs).

- The *Emergency Farm Reconstruction Project* (\$10.6 million)⁹, which has been developed jointly with UNMIK and FAO and cofinanced by the Dutch Government, will help jumpstart agricultural production over the next two to three cropping seasons and support the re-launching of the rural economy by investing in key farm assets (cattle and farm mechanization) and key agricultural services (veterinary services and policy analysis capacity building). The project supports vulnerable households in targeted villages and municipalities in attaining minimum levels of agriculture production and food security (Box 3).

Box 3. Targeting the Poor Under the Emergency Farm Reconstruction Project

The project supports farm households which have particularly suffered from conflict damage and will not recover without external support to re-invest in their farm assets. A targeting mechanism has been designed to identify and support the most needy communities, and farm households within these communities. The main objective of this targeting process is to identify villages and households on the basis of their unmet needs, to allocate resources along project objectives, and minimize conflict amongst potential recipients.

The beneficiary selection is implemented by two international NGOs, Action Against Hunger and Mercy Corps International, and one national NGO, the Mother Theresa Society under the supervision of an international rural sociologist with the FAO Project Management Team in Pristina. The beneficiary selection is based on a participatory process including (i) consultations at municipality level to finalize the list of beneficiary villages; (ii) an information campaign in the selected villages; and (iii) meetings and consultation at village level to select beneficiary farmers. Given the prevalence of women in livestock activities in rural Kosovo, benefits from the cattle restocking and veterinary components are skewed towards women in the selected communities.

- The *Pilot SME Line of Credit* (\$5 million), a joint project with the European Agency for Reconstruction (EUAR), aims at jumpstarting production and economic activity of the private sector.¹⁰ Loans to SMEs will be for much needed inputs and repairs, which in turn are expected to revive industrial production and create employment, and ultimately contribute to poverty alleviation. In addition, this project will reinforce reforms in the financial sector introduced in recent months by UNMIK to help re-establish basic credit management capacity and loan administration skills of newly emerging banks, and to assist SMEs by increasing financial discipline and planning capacity through the credit process. This project is seen by UNMIK as a

⁹ This amount includes a project preparation grant of \$0.6 million.

¹⁰ EUAR is the newly established implementing agency of the European Commission's assistance to Kosovo, which took over the role of TAFKO. The Grant Agreement for this project has been negotiated with UNMIK, and its approval awaits the setting up of the Interim Credit Unit and its adoption of a satisfactory financial management system.

platform to facilitate the channeling of additional donors' funds to SMEs within an approved framework. Preparation of this project has been closely coordinated with IFC, and will benefit from the joint IFC/Bank Balkans Enterprise Facility which provides advisory services to private sector companies and helps address constraints in the enabling business environment.

17. **Implementation capacity.** Project preparation and identification of implementation arrangements have turned out to be difficult, as expected. In the initial period when UNMIK was in the formation stage, daily crisis management and lack of staff made it difficult for UNMIK to focus on reconstruction. While the situation has improved quite significantly over time, in particular with the creation of the Central Fiscal Agency, the Central Procurement Unit, and the Department of Reconstruction, UNMIK's project implementation capacity remains limited. Therefore, while UNMIK has been our legal counterpart for project implementation, we had to identify other implementing agencies (NGOs, UN agencies) with the capacity to carry out the projects on behalf of UNMIK. On the other hand, in the context of our agriculture and social sector operations, we provide assistance to UNMIK in strengthening its institutional capacity in policy making and implementation.

18. **Project processing and approval.** As foreseen in the TSS, an Advisory Group, including experts from the Post-conflict Unit, has been set up in the ECA Region to provide guidance to Kosovo project teams on implementation issues and facilitate project processing. This group has helped ensure that the lessons of other emergency and post-conflict situation are taken into account and that the Bank's fiduciary requirements, including the need for transparency and accountability in the use of funds, are appropriately addressed in project design and execution. In line with the decision of the Executive Directors, grants from the Trust Fund for Kosovo have been approved by the Regional Vice President.

19. **IFC.** IFC has made an important contribution to the initial revival of the payment and banking system by promoting the establishment of the first bank that was licensed in Kosovo following the conflict. The Micro Enterprise Bank (MEB) provides account management, money transfers, loans and cashless payment transactions to micro and small enterprises, as well as individual customers. As noted earlier, IFC has also been closely involved in the preparation of the Pilot SME Credit Line, and is expected to provide continued support to the development of a vibrant private sector through the joint IFC/Bank Balkans Enterprise Facility which will soon open an office in Pristina.

20. **MIGA.** MIGA has been exploring the feasibility of a trust fund for Kosovo from which it could issue guarantees against the risks of transfer restrictions, expropriation, war and civil disturbances and breach of contract. Depending on donor interest to fund such as a scheme, MIGA would be ready to set up and administer it.

21. **Field presence.** The Bank has established a small liaison office in Pristina which has been providing critical support to visiting missions that work in a fragile security environment and under difficult logistics conditions. The liaison office has also been essential in maintaining the dialogue with UNMIK, Kosovar leaders and members of civil society, and representatives of the international community, as well as in assisting

project preparation and supervision. Agreement has been reached with UNMIK on privileges, immunities and exemptions enjoyed by the Bank's permanent field presence and staff visiting Kosovo.

V. Plans for FY2001

22. Our strategy as described in the TSS remains valid; supporting sustainability of the reconstruction and recovery program continues to be our overarching objective. As explained in para. 28 in more detail, we propose a \$35 million second tranche for the continuation of our assistance program, to be committed by October 2001. Given the active involvement of the donor community in Kosovo and our limited resources, in designing our FY01 program we follow four guiding principles:

- *Comparative advantage:* Among the international players active in Kosovo, the Bank has a comparative advantage in (i) providing economic policy advice combined with budget support to UNMIK; (ii) helping institution building, in particular, the creation of local capacity in policy formulation and implementation; and (iii) designing sustainable sector policies and institutions in combination with financing selective rehabilitation of infrastructure. In addition, the Bank is being called on by donors to make an assessment on a regular basis of the implementation of UNMIK's economic policy program.
- *Partnerships/catalytic role:* We wish to maximize our impact by getting involved in those sectors where we can work in partnership with other donors in an agreed framework, and where we can contribute to the creation of a common platform for donor interventions and catalyze additional donor resources.
- *Selectivity:* On the basis of consultations with UNMIK and key donors, in particular the EC which is the single largest donor, we have also defined areas where we do not plan to get involved. These include highly capital intensive investments such as housing reconstruction, the rehabilitation of power plants and coal mines (although we might provide support for the design of a long-term least cost investment plan), telecommunications and landmine clearance.
- *Flexibility:* We need to remain flexible to be able to respond rapidly to emerging needs during the year. The situation in Kosovo remains in flux, and lessons learned in other post-conflict situations demonstrate that flexibility is essential to stay relevant in the field. Since rebuilding Kosovo, both physically and institutionally, is a collective effort of the international community, we need to be able to flexibly adjust our program in light of what other donors are doing. In some instances we may need to revisit our planned involvement if we find out that other donors are able to meet those needs. It also means that we may consider the increase of grant amounts for earlier approved projects if they work well and there is not enough cofinancing from others.

23. While our planned activities should be seen in the context of our overall FY00-01 program, in FY01 we intend to focus on two main areas: (i) support of economic reforms

and institution building; and (ii) support of sustainable sector policies and institutions linked to selective rehabilitation of infrastructure (Annex II). Capacity building of the evolving departments of the joint interim administration and engaging the Kosovar community in an economic policy dialogue will represent a major challenge.

Support of economic reforms and institution building

24. We plan to continue the provision of *budget support* (Economic Assistance Grants II and III) to help UNMIK fill the financing gaps of Kosovo's 2000 and 2001 budgets and address some of the key economic policy issues:

- the formulation of a sustainable 2001 budget that is increasingly financed through local taxation and user fees and, therefore, with reduced reliance on external donor support; as well as the development of fiscal institutions ensuring the efficiency and probity of public spending;
- the establishment of a liberal trade and customs regime that permits Kosovo to realize its potential for growth and exports in the context of its geographical location in the south-central Balkans as well as take advantage of the enabling arrangements being fostered by the Stability Pact and the European Union;
- the creation of a reformed framework for encouraging the growth of private, small and medium enterprises and transferring viable existing public enterprises into private hands; and
- the development of a simple, sustainable and well targeted system of social protection for the vulnerable elements of the population to replace the ad hoc humanitarian interventions of the past decade.

25. The proposed budget support operations will be accompanied by *technical assistance projects in the areas of private sector development and social protection*, as well as by economic and sector work, including a *Poverty Assessment* to guide the formulation of a social protection program, and *policy notes on fiscal, trade and social policy issues*.

Support of sustainable sector policies and institutions linked to selective rehabilitation of infrastructure

26. We plan to support selected infrastructure sectors based on the guiding principles described above and in line with UNMIK's reconstruction investment program for 2000:

- In the *transport sector*, we would support the establishment of the Road Administration and the adoption of budgets and policies which help ensure the future sustainability of road maintenance. Our grant will finance road maintenance, to prevent further deterioration of the road conditions, following decades of maintenance backlog. This project would be part of a broader program we have developed in full coordination with UNMIK and donors involved in the road sector.

- In the *water sector*, where many donors are involved, UNMIK has requested the Bank to develop a demonstration project in the Gjakova region, which has been one of the most affected by the conflict, to develop an effective water management system, including institutional and policy changes that could be replicated throughout Kosovo.
- In the *energy sector*, we have been asked to help UNMIK define a long-term least cost sector investment program, while the very significant, immediate rehabilitation needs are being funded by the EU and other donors. While our limited financial contribution does not allow us to make an important contribution to immediate rehabilitation, we can assist UNMIK in developing a long-term strategy for the energy sector.
- We also intend to scale up the Community Development Fund Project, currently financed by a Post-Conflict Fund grant and donor resources, for funding *small local infrastructure and social projects*.

27. Finally, based on the findings of the social assessment, we plan to prepare a small community-based social capital project to facilitate social cohesion and reconciliation in one of Kosovo's communities. This project would be financed by Italy's Development Cooperation through the Social Development Initiative for Southeast Europe.

28. *Justification for the higher amount of the range.* The TSS envisaged a second tranche of \$25-35 million from net income for the continuation of our program in Kosovo. Based on the reasons described below, it is now proposed that \$35 million be allocated to the Trust Fund for Kosovo, to be committed by October 2001, enabling the commitment of a total of \$60 million over a two-year period since the approval of the TSS.

- Kosovo is in a nascent stage of building its governance structure, including its basic economic institutions, and its budget relies heavily on donor support. Only few donors can provide critical fiscal support, and even those who are able to do so, look to the Bank for its assessment of the underlying economic policies. Additional grant funding would, *inter alia*, enable us to continue the intensive economic dialogue with UNMIK and provide essential budget support.
- Additional financial assistance would also help us play the catalytic role that donors expect us to play. In selected sectors, as described above, we are designing "platform" or "demonstration" projects, which focus on sustainable sector policies and ensure a coordinated donor intervention. This is much encouraged by UNMIK. A higher amount of resources would also allow us to proceed with these operations as well as respond in a flexible manner to emerging needs during the year.
- Finally, as co-chair of the High Level Steering Group for Southeast Europe and the donors' conferences for Kosovo, it is important that we demonstrate our continued commitment to the reconstruction and economic recovery of Kosovo. While our share

in the total amount pledged is modest (in the 4-5 percent range), committing \$60 million would enhance our credibility in the overall resource mobilization effort.

VI. Risks

29. The TSS described several risk factors: some which were applicable to any post-conflict situation and others which were more Kosovo-specific. The former ones included the fragility of institutions complicated by the legacy of the conflict, the uncertain security environment, and the potential for misuse of funds. As described in para. 2 and para. 30, there has been important progress in the creation and strengthening of institutions at the central level, and following municipal elections in the fall, we expect the consolidation of local institutions. Nevertheless, interethnic cooperation remains problematic both at the central and local level, aggravated by the volatile security environment and the recent upsurge in localized violence. While the security situation has not prevented us from moving ahead with our assistance program, it does constrain our access to certain areas of Kosovo, and requires careful mission planning, and appropriate security and logistics support by our liaison office. As regards the potential misuse of our funds, we have put in place several safeguards to mitigate this risk. First, we have worked closely with UNMIK, together with the IMF, in setting up the Central Fiscal Agency and designing its control procedures. Second, we have selected project implementing agencies with appropriate financial management capacity and have required annual audits of project accounts.

30. The Kosovo-specific risks noted in the TSS included the uncertainty, at that time, of UNMIK's ability to establish itself as a viable and effective transitional administration in the near term and thereafter to ensure hand-over to a provisional local administration. With the recent inclusion of Kosovar political leaders and experts in the JIAS, and the abolishment of the parallel political structures, UNMIK has made an important step towards a more sustainable and locally legitimized system of governance. This has also helped us to clarify who our local counterparts are, and we are putting increasing emphasis on engaging Kosovar leaders in our dialogue and on capacity building within the JIAS.

31. The second set of Kosovo-specific risks related to the delicate balance that must be struck in ensuring the territorial integrity of FRY on the one hand, and the "substantial autonomy" of Kosovo on the other, as provided for under the UN Security Council Resolution. There are several areas in which economic efficiency may dictate solutions that could be politically controversial. UNMIK has addressed some of the politically sensitive economic issues, e.g. allowing the use of foreign currencies in local transactions and changing the customs system, but others, primarily related to the clarification of property rights and privatization remain to be tackled. In our policy dialogue and operations, we have considered jointly with UNMIK what is feasible under the current circumstances.

32. Finally, instability in the rest of FRY was noted as a critical risk factor influencing the success of the political process as well as the reconstruction and recovery effort in the province. The past 12 months witnessed important progress on both fronts in Kosovo. Nevertheless, major uncertainties remain regarding political developments in FRY, and

their impact on Kosovo, with implications on any longer term Bank involvement (para. 33). We have been monitoring these events through our continuing Watching Brief on FRY, and through our intensive dialogue with our donor partners in the context of the High Level Steering Group for Southeast Europe and its working level counterpart.

VII. Possible Future Assistance

33. The unclear nature of a future political settlement creates an environment of uncertainty, and raises the question of the duration and extent of our involvement in Kosovo. Nine months after the preparation of the Transitional Support Strategy it is as hard to predict as it was then when a final political settlement will be reached and what form it will take. The Resolution establishing the Trust Fund for Kosovo envisaged a two-year period of use, until October 2001 when any remaining uncommitted funds should be transferred to IDA, unless the Board decides otherwise.¹¹ We plan to commit the proposed total of \$60 million by that date, i.e. in about two years from the date of the TSS. Since the nature and timing of an eventual political settlement, as well as political developments in FRY, will have important implications on the form of any longer term Bank involvement in Kosovo, we plan to return to the Board within 12 months to assess whether the extension of the Trust Fund and any further replenishments are justified. In this context, we also intend to review prospects for Kosovo's achieving economic sustainability and reducing its heavy reliance on donor support over the medium term.

VIII. Recommendations

34. In light of the foregoing, I recommend that the Executive Directors propose to the Board of Governors, in the context of the allocation of IBRD's FY00 net income, the transfer of \$35 million to the Trust Fund for Kosovo to enable the Bank to continue its assistance program. These funds should be committed by October 2001 under the same procedures as set out in the Transitional Support Strategy. An assessment of the Bank's future role in Kosovo will be presented to the Board within 12 months.

James D. Wolfensohn
President

By Sven Sandström

June 23, 2000

¹¹ Resolutions No. 99-7 and No. IDA 99-4, paragraph 7 (b).

SELECTED ECONOMIC AND SOCIAL DATA

Area:	11,000 square kilometers
Population:	2.2 million
Ethnic composition: ¹²	Albanian - 82 percent; Serb - 10 percent; Others - 8 percent
Life expectancy at birth: ¹³	69.8 years (males); 76.6 years (females)
Total fertility rate: ¹⁴	3.2 births
GDP per head: ¹⁵	US\$400
Share of key sectors: ¹⁶	Industry - 33.8 percent; agriculture - 28.8 percent; Other - 37.4 percent
Natural resources:	Lead, zinc, nickel, coal, magnesium, lignite, kaolin, quartz, asbestos, limestone, marble, chrome and bauxite.
Major industries:	Metallurgy, electric power, textiles, handicrafts and construction

¹² Estimates of Albanian scholars (Limani, 1992) in "Demography of Kosovo before the War," by Gjonca Arjan, 1999.

¹³ 1996 figures quoted in "Demography of Kosovo before the War," by Gjonca Arjan, 1999.

¹⁴ 1996 figures quoted in "Demography of Kosovo before the War," by Gjonca Arjan, 1999.

¹⁵ 1995, Riinvest. This might be an underestimated figure given that the official data do not capture the informal economy and remittances of Kosovar Diaspora.

¹⁶ 1996 figures, Riinvest.

INDICATIVE PROGRAM FOR KOSOVO
(\$ million)

FY 00		FY 01	
PCF	Community Development Fund (a)	1.0	
	Budget Support (a)	1.0	
		<u>2.0</u>	
KTF	Economic Assistance Grant (a)	5.0	Economic Assistance Grant II
	Education and Health Project (a)	4.4	Private Sector Development TA
	Em. Farm Reconstruction Project (a)	10.6	Economic Assistance Grant III
	Line of Credit for SMEs (n)	5.0	Social Protection TA
			Transport
			Water
			Energy
			Community Development
		<u>25.0</u>	<u>35.0</u>
	Reconstruction and recovery program (c)		Dissemination of the economic report
	Economic report (c)		Dissemination of the social assessment
	Agriculture sector note (c)		Poverty assessment
	Social assessment (o)		Policy notes on fiscal and trade issues
			Financial sector strategy update
			Social sector policy notes

PCF: Post-Conflict Fund
TFK: Trust Fund for Kosovo
(a) Approved
(n) Negotiated
(c) Completed
(o) Ongoing