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**MEMORANDUM OF THE PRESIDENT
OF THE
INTERNATIONAL DEVELOPMENT ASSOCIATION
AND THE
INTERNATIONAL FINANCE CORPORATION
TO THE
EXECUTIVE DIRECTORS
ON A
COUNTRY ASSISTANCE STRATEGY
OF THE WORLD BANK GROUP
FOR THE
DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA**

April 23, 2003

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The last Country Assistance Strategy for Sri Lanka (Report No. 15633-CE) was discussed by the Board on June 13, 1996 and a Progress Report (Report No. IDA/R98-190) was discussed on January 19, 1999.

Currency and Equivalents

Currency Unit = Sri Lankan Rupee (Rs.)
US\$1 = Rs. 96.855 (as of February 28, 2003)

Fiscal Year

January 1 – December 31

Abbreviations and Acronyms

AAA	Analytical and Advisory Activities	LIL	Learning and Innovation Loan
ADB	Asian Development Bank	LTTE	Liberation Tigers of Tamil Eelam
BOC	Bank of Ceylon	MDG(s)	Millennium Development Goal(s)
BOT	Build, Operate, Transfer	MFA	Multi-Fibre Arrangement
CAN	Country Assistance Note	MIGA	Multilateral Investment Guarantee Agency
CAS	Country Assistance Strategy	MOF	Ministry of Finance
CBO(s)	Community Based Organization(s)	MOU	Memorandum of Understanding
CBSL	Central Bank of Sri Lanka	MTBF	Medium-Term Budget Framework
CDC	Commonwealth Development Corporation	NBFI(s)	Non-Bank Financial Intermediaries
CDD	Community Driven Development	NE	North East
CEB	Ceylon Electricity Board	NEIAP	North East Irrigated Agriculture Project
CFAA	Country Financial Accountability Assessment	NERF	North East Reconstruction Fund
CFSS	Consumer Finance & Socioeconomic Survey	NGO(s)	Non-Governmental Organization(s)
COPA	Committee on Public Accounts	NSL	National Security Levy
COPE	Committee on Public Enterprises	OED	Operations Evaluation Department
CPAR	Country Procurement Assessment Review	PA	People's Alliance
CPC	Ceylon Petroleum Corporation	PB	People's Bank
DDR	Disarmament, Demobilization and Reintegration	PER	Public Expenditure Review
DEC	Development Economics Vice Presidency	PHRD	Policy and Human Resource Development
DO	Development Objective	PRGF	Poverty Reduction and Growth Facility
DPR	Development Policy Review	PRS(P)/(C)	Poverty Reduction Strategy (Paper)/(Credit)
EPF	Employee Provident Fund	PSIDC	Private Sector Investment Development Corporation
ERP	Emergency Reconstruction Program	PSP	Private Sector Participation
ESW	Economic and Sector Work	PSR	Project Supervision Report
EU	European Union	QAG	Quality Assurance Group
FDI	Foreign Direct Investment	RERED	Renewable Energy for Rural Economic Development
FSAP	Financial Sector Assessment Program	RRR	Relief, Rehabilitation and Reconciliation
FY	Fiscal Year	RSL	Regaining Sri Lanka: Vision & Strategy for Accelerated Development
GDP	Gross Domestic Product	SBA	Stand-By Arrangement
GEF	Global Environmental Facility	SIRHN	Sub-Committee on Immediate Relief & Humanitarian Needs
GEP	General Education Project	SLIC	Sri Lanka Insurance Company
GNFS	Goods and Non-Factor Services	SLT	Sri Lanka Telecom
GNP	Gross National Product	SME(s)	Small and Medium Enterprise(s)
GST	Goods and Services Tax	SOE(s)	State-Owned Enterprise(s)
HIES	Household Income and Expenditure Survey	TA	Technical Assistance
IBRD	International Bank for Reconstruction & Devlp	TETD	Teacher Education and Teacher Deployment
ICR	Implementation Completion Report	TEWA	Termination of Employment of Workmen Act
IDA	International Development Association	UK	United Kingdom
IDF	Institutional Development Fund	UN	United Nations
IDPs	Internally Displaced Persons	UNDP	United Nations Development Program
IFC	International Finance Corporation	UNESCO	UN Educational, Scientific and Cultural Organization
ILO	International Labor Organization	UNF	United National Front
IMF	International Monetary Fund	UNFPA	UN Population Fund
IRQUE	Improving Relevance & Quality of Undergraduate Education	UNHCR	UN High Commissioner for Refugees
IT	Information Technology	UNICEF	UN Children's Fund
IP	Implementation Progress	VAT	Value Added Tax
JBIC	Japan Bank for International Cooperation	WBI	World Bank Institute
JSA	Joint Staff Assessment	WHO	World Health Organization
JSDF	Japan Social Development Fund	WTO	World Trade Organization

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SRI LANKA: Country Assistance Strategy

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SRI LANKA
Country Assistance Strategy
Executive Summary

i. The last Country Assistance Strategy (CAS) for Sri Lanka—discussed at the Board on June 13, 1996—was prepared at a time of great uncertainty with regard to the prospects for peace, political stability and economic reform. For a number of years the uncertainties continued: Sri Lanka went through frequent elections that slowed the momentum for structural reform and the domestic security situation—most notably, an escalation of the nearly two decade-long civil conflict waged between the Sri Lankan army and the Liberation Tigers of Tamil Eelam (LTTE)—took a tremendous toll on development of this unique island nation.

ii. Since late-2001, however, the situation in Sri Lanka has shown noticeable improvements. On the peace front, a Memorandum of Understanding signed between the Government and LTTE in February 2002 has resulted in a permanent cease-fire. Five successful rounds of peace discussions—facilitated by Norway—have taken place and with significant advances being made, there is great optimism that the long-standing conflict can be resolved. On the political front, in December 2001, a private sector-oriented Government—headed by Prime Minister Mr. Ranil Wickremasinghe—assumed control and has moved forward decisively in starting to implement a comprehensive reform program. Finally, on the economic front, Sri Lanka has begun to experience a gradual recovery and the economy is currently growing at an annual rate of more than 5 percent. With these developments, today Sri Lanka faces a rare window of opportunity.

iii. The Executive Directors may wish to discuss:

- The planned significant increase in IDA activity in response to the peace process and poverty reduction strategy (PRS);
- The balance between the lending and non-lending programs;
- The choice of instruments to deliver the lending program; and
- The appropriateness of the CAS outcomes given the PRS.

iv. The Government has articulated an economic program and poverty reduction strategy: *Regaining Sri Lanka: Vision and Strategy for Accelerated Development (RSL)*. This is an ambitious proposal to eliminate factors which inhibit the restraints on private sector activity and to change the role of the state, while addressing the key elements of poverty. The principal objectives of RSL include: (i) building a supportive macroeconomic environment; (ii) reducing conflict-related poverty; (iii) creating opportunities for pro-poor growth; (iv) investing in people; (v) empowering the poor and strengthening governance; and (vi) implementing an effective monitoring and evaluation system.

v. The CAS program supports the Poverty Reduction Strategy and is organized around three central themes: ***Peace, Growth and Equity***. First, a return to peace and restoration of domestic security are critical to create a framework for sustainable poverty reduction and growth and ensure that the fiscal burden remains tolerable. It is also important towards ensuring that the most vulnerable poor groups—i.e., the displaced and those in conflict-affected areas—are reached. Secondly, economic growth is the main instrument for achieving prosperity and creating more resources for distribution. Finally, ensuring a balance/equity within the society is essential, especially with deep pockets of poverty existing in the South and North East. Sri Lanka's ability to attain the Millennium Development Goals (MDGs) will be influenced by equitable progress towards improving social and human development indicators. The assistance strategy is a comprehensive one in which the International Development Association (IDA), the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA)

all play significant roles. Capacity building is an integral element of the strategy and the World Bank Institute (WBI) plays a central role in implementing this cross-cutting theme.

vi. The CAS is “results-focused.” In the thematic area of peace, key outcomes that the CAS is designed to support include: (i) restored infrastructure in health, education and irrigation; and (ii) technical capacity built to implement the reconstruction and poverty reduction efforts. In the area of growth, key CAS outcomes include: (i) legal frameworks established to increase flexibility in the labor and land markets; (ii) regulatory environment conducive to private sector participation established; (iii) the time and formal cost of business start-up reduced; and (iv) agricultural producers receiving more consistent price signals and clearer land title. Finally, in equity, key CAS outcomes include: (i) improved access to and quality of public services in education, health and water supply; and (ii) expanded degree of empowerment of communities to address their own development needs.

vii. The *base case* lending program consists of an average of four operations per year for a total of US\$800 million of IDA resources during FY03-FY06. In each year, the lending program would be anchored in a Poverty Reduction Support Credit (PRSC) providing program support to the implementation of the PRS. This would be complemented by two to four investment/sectoral operations per year to support key programs in the focus areas. Given the intensity of the conflict, Sri Lanka qualifies for a limited amount of IDA grants during FY03 and FY04. Key operations in the equity theme—i.e., in rural water, health and rural poverty—would be financed by IDA grants. Lending activities would be accompanied by a strong non-lending program, with a particular focus on public expenditure and poverty issues. In the base case, it is assumed that progress would continue towards achieving a lasting peace. To remain in the base case, specific triggers must be met including: (i) maintaining satisfactory macroeconomic performance; (ii) successful implementation of the economic reform program; (iii) progress in addressing equity concerns; and (iv) satisfactory portfolio management.

viii. The *high case* scenario would have a lending volume approximately 25 percent above the base case. In addition to maintaining performance as envisioned under the base case, additional improvements would be expected in the areas of fiscal management, private participation in infrastructure, public sector management and decentralization. The strategy also describes two types of *low case* scenarios: (i) a situation triggered by a breakdown of the peace process and the resumption of hostilities or the serious lagging behind of structural reforms; and (ii) a deeper low case scenario—i.e., an exit strategy—if the peace process were to break down entirely and hostilities were to break out on a national scale.

ix. A CAS Completion Report—evaluating performance under the previous CAS—has been prepared and the lessons learned have been subsequently incorporated. Furthermore, the CAS contains a comprehensive country program results framework that links together the different levels of results—i.e., the country’s longer-term development agenda (based on the PRS/RSL) and the shorter-term goals to be achieved during the CAS period and supported by the Bank’s interventions. During initial implementation of the CAS, special focus will be placed on refining the results framework by establishing: (i) baseline information and benchmarks for the various indicators to be monitored during implementation; and (ii) a solid monitoring and evaluation capacity.

x. Because of the historic moment at which Sri Lanka finds itself, the strategy is inherently risky. The Government and indeed the LTTE are themselves being very bold and taking enormous risks with respect to their own political futures for the sake of a better future for the people of Sri Lanka. The Bank should be prepared to accept the risks of this strategy so long as the two parties remain committed to achieving peace and laying the foundation for a renewed attack on poverty. Therefore, while the strategy has very high risks, it has potentially very high rewards in a country that for too long has been performing below its potential. The Bank is adopting appropriate strategies to mitigate the risks.

xi. Sri Lanka now has the opportunity to break out of the conflict and follow a path of sustained development and progress for all its people. This CAS presents a coherent strategy for how the World Bank Group should support Sri Lanka to help this opportunity be realized.

SRI LANKA

COUNTRY ASSISTANCE STRATEGY

INTRODUCTION

1. The last Country Assistance Strategy (CAS) for Sri Lanka was considered by the Board on June 13, 1996 and a Progress Report was discussed on January 19, 1999. Since that time, Sri Lanka has been through numerous elections that slowed the momentum for structural reform. At the same time, the domestic security situation worsened as a result of the intensification of the nearly two decade-long civil conflict between the Sri Lankan army and the Liberation Tigers of Tamil Eelam (LTTE). This period of uncertainty has been costly to the development of this unique island nation.

2. In the last year, however, the country has experienced encouraging developments in many respects. First and foremost, there has been progress towards peace and improved domestic security. The Government and LTTE signed a Memorandum of Understanding (MOU) on February 23, 2002 that resulted in a permanent cease-fire. Both sides have demonstrated their commitment to finding a lasting solution to the conflict and five successful rounds of negotiations—facilitated by Norway—have taken place. Second, a more optimistic political environment has emerged. The private sector-oriented Government—headed by Prime Minister Mr. Ranil Wickremasinghe—which took office in December 2001 has taken earnest and decisive steps in implementing a far-reaching economic reform program. Finally, an economy recovery is underway with growth currently at an annual rate of more than 5 percent. Today, Sri Lanka is poised to capitalize on these promising developments.

3. This CAS has been drawn up on the basis of the post-conflict situation in which Sri Lanka finds itself. As such, the lessons from other post-conflict situations have been incorporated, but it has been decided not to apply the IDA post-conflict framework to this case. Although many features of post-conflict countries apply to Sri Lanka, the state did not break down during this conflict, even within the conflict-affected areas of the country. Therefore, a number of the challenges that other post-conflict countries have faced are not present.

I. SOCIAL, POLITICAL AND ECONOMIC CONTEXT

A. *Social Context*

4. Sri Lanka—long an outlier among developing nations—holds a unique position in South Asia. It was one of the first developing countries to provide universal health and education coverage and promote gender equality and social mobilization. As a result, Sri Lanka achieved human development outcomes comparable to those of high income countries and surpassed some of the Millennium Development Goals (MDGs) at an early stage of its development process (see Box 1 and Appendix VI). Sri Lanka has largely eradicated destitution and its long-standing commitment to human development has ensured that even the poor have relatively good health and education. For the most part, economic growth has been reasonable, and despite the acceleration of the conflict in the 1990s, the country's per capita income (US\$830) remains the second highest in South Asia (behind Maldives).

Box 1: Sri Lanka and the Millennium Development Goals		
Millennium Development Goals (MDGs)	Sri Lanka's position with respect to the MDGs	Looking beyond the MDGs
Reduce the proportion of people living in extreme poverty by half between 1990 and 2015.	Poverty incidence declined from 31 percent to 25 percent between the mid-1980s and mid-1990s.	Large regional disparities in poverty exist.
Enroll all children in primary school by 2015.	Net primary enrollment rates exceeded 97 percent by the late-1990s.	Quality, relevance and contribution of education to social inclusion in question.
Make progress towards gender equality and empowering women by eliminating gender disparities in primary and secondary school by 2005.	Gender equality achieved in primary, secondary and even tertiary levels.	Gender disparities exist in access to employment opportunities (e.g., women mostly in low-skill, low-paid jobs in agriculture and industry).
Reduce infant and child mortality rates by two-thirds between 1990 and 2015.	Between the mid-1970s and late-1990s, infant mortality fell from 44 to 15 per 1,000 live births; under-five mortality fell from 100 to 18.	High child malnutrition (33 percent of children under age 5) and low birth weight (25 percent of infants).
Reduce maternal mortality rates by three-quarters between 1990 and 2015.	Maternal mortality rate is 60 per 100,000 live births, on par with middle income countries.	High prevalence of anemia among pregnant women.
Provide access for all who need reproductive health services by 2015.	Contraceptive prevalence rate is high at 66 percent; poorest country in the world to have achieved below replacement fertility; 95 percent of births attended by health staff.	Demographic transition with an unprecedented aging of the population. Proportion of population over 60 projected to increase from 9 percent to 20 percent by 2025.
Implement national strategies for sustainable development by 2005 to reverse the loss of environmental resources by 2005.	Since 1994, two successive national environmental action plans have been developed and are presently under implementation.	Implementation slow in many areas due to institutional weaknesses and lack of clear, monitorable targets.
<i>Note:</i> The statistics do not include the North East where the state of poverty is reportedly high.		
<i>Sources:</i> <i>Regaining Sri Lanka: Vision and Strategy for Accelerated Development</i> , Government of Sri Lanka, January 2003 and staff estimates.		

5. A poverty assessment—*Sri Lanka: Poverty Assessment*¹—was finalized in FY02. Based on this and other analysis, it is estimated that 25 percent of Sri Lankans remain below the national poverty line; there are large disparities in poverty incidence among regions; and the rural population remains especially vulnerable to income fluctuations². Whereas the Western province—containing the capital city and most of the country's manufacturing and services—has a relatively low incidence of poverty, the North, East and other areas affected by the conflict have high levels of material deprivation and human suffering. While it has not been possible to carry out surveys in the North and East in recent years due to the conflict, it is likely that the poverty conditions in these regions are far more severe than in other parts of the country and compounded by massive destruction of economic and social infrastructure.

6. Over 90 percent of Sri Lanka's identified poor live in rural areas of the South and on tea/rubber estates in the Central region where the depth and severity of poverty are almost twice as high as in urban areas. Small-scale subsistence agriculture—especially paddy farming—and wage labor (in farms or plantations) are the main sources of income for most of the poor. Incidence of poverty varies only slightly across ethnic groups, although plantation estate workers (who represent about 4 percent of the poor and are mostly Indian Tamils) are among the poorest, often deprived of basic infrastructure and

¹ Report No. 22535-CE, June 2002.

² This is based on a Household Income and Expenditure Survey (HIES) carried out in 1995/96 and does not include the North East. A new survey will be completed in mid-2003 and together with an FY03 Social Assessment of the Conflict-Affected Areas will allow for a more complete up-to-date picture of poverty in Sri Lanka.

other public services, and face severe difficulty integrating into the economy and society due to the remote location of estates, language barriers, and for some, lack of citizenship cards.

7. The poor in Sri Lanka are relatively well-protected due to free and universal access to health and education services, large income transfer programs—such as Samurdhi—and substantial subsidy schemes. The early successes in human development outcomes undoubtedly result from these long-standing policies. But there are weaknesses. While access to health and education services is well-distributed, quality—especially in poor areas—remains inadequate. Poor households also face shortfalls in access to other basic services—e.g., among the poorest households, only 38 percent have electricity, 55 percent safe sanitation and 61 percent safe drinking water. Access to English language and technical education—both in great demand—is also low in poor regions. Moreover, social protection programs have become highly politicized and Samurdhi is presently available to 60 percent of the population.

B. Political Developments

8. Sri Lanka has had numerous elections since the last CAS—including Provincial Councils (April 1999), Presidential (December 1999), Parliamentary (October 2000 and December 2001) and local (March 2002). The United National Front (UNF)—traditionally supportive of economic liberalization—won a near majority in the 225-member legislature in the December 2001 parliamentary elections. With the support of allied parties, the UNF formed a Government with a two seat majority, returning to power after seven years in the opposition. Mr. Ranil Wickremasinghe—Prime Minister from 1993-1994 and a cabinet minister from 1977-1993—was sworn in as Prime Minister on December 9, 2001. Following this, in the March 2002 local elections the UNF won a sizeable majority of the seats, strengthening its mandate to pursue a peace and economic reform agenda.

9. Mrs. Chandrika Kumaratunge, leader of the People's Alliance (PA), first became President in 1994. After being re-elected in 1999, her term expires in December 2005. Under the constitution, the President is Chief Executive, while Parliament retains financial and legislative control. The party that controls the legislature nominates the Cabinet of Ministers. Except for a brief interlude in 1994, this is the first time in Sri Lankan history there is a President from one party and a legislature controlled by another. Both sides are pursuing a strategy of “cohabitation”, with the Prime Minister making key policy recommendations to Cabinet, which is chaired by the President. However, the President retains the power to dismiss the Government after one year in office.

10. A top priority of the new administration is to end the nearly two decade-old civil conflict that has placed severe stress on Sri Lanka (see Box 2)³. Early on in his administration, the Prime Minister revived internationally-supported initiatives to undertake peace talks with the LTTE. The Government and the LTTE announced a cessation of hostilities in December 2001 and signed a permanent cease-fire in February 2002 under a Norwegian-brokered Memorandum of Understanding (MOU). To date, this is the longest cease-fire to hold. The Government has removed the economic embargo imposed on rebel-held areas, lifted restrictions on the movement of civilians, rescinded restrictions on fishing and

Box 2: The Humanitarian Effects of the Conflict

The conflict in Sri Lanka has led to loss of life, the displacement of persons belonging to all ethnic groups and the destruction of infrastructure, health care facilities and schools. Approximately 2.5 million persons lived in areas of direct military activity—65,000 people have been killed, 800,000 are internally displaced, including 172,000 living in refugee camps and another 700,000 left the country. There are 30,000 war widows and an estimated 300,000 displaced children in the North East where the school drop out rate is double the national average. The infant mortality rate in the North East is twice the national average, the maternal mortality rate is thrice the national average and 92% of malaria deaths are reported from the region. There are an estimated 1.8 million landmines in the North—a per capita incidence comparable to Angola.

³ For a brief analysis of the root causes of the conflict, see Appendix I.

accelerated its de-mining program. The military has vacated schools and public buildings in the North East and most paramilitary groups have been disarmed. The LTTE has re-opened roads in areas under its control for vehicular traffic after a gap of 12 years. It has also opened political offices in military-controlled areas in an effort to participate in the political process and has expressed willingness to give up its demand for a separate state under certain conditions. An international team monitors the truce and approximately 260,000 internally displaced persons (IDPs) have spontaneously returned to their original homes since the cease-fire, with more returning daily.

11. The Government de-proscribed the LTTE in September 2002 and Norwegian-facilitated peace discussions commenced in Thailand on September 16, 2002. Further discussions were held in October 2002, December 2002, January 2003 and February 2003. Both sides have agreed to set up mechanisms to oversee humanitarian and reconstruction activities in the North East—lead by the Sub-Committee on Immediate Relief and Humanitarian Needs (SIRHN)—and on the broad outlines of a future federal structure of governance for Sri Lanka. Following the January 2003 discussions, the Bank was invited to act as administrator for the North East Reconstruction Fund (NERF) through which humanitarian and rehabilitation programs will be implemented (see paragraph 40) in the conflict-affected areas.

C. *Macroeconomic Performance*

12. Despite the prolonged civil conflict and several external shocks, Sri Lanka has sustained reasonable economic growth of around 5 percent from 1996-2000 (see Table 1). Inflation generally declined over this period and through 1998 the current account deficit declined significantly in line with strong growth in exports and remittances. This, combined with labor migration (mainly to the Middle East and accounting for over 12 percent of the labor force by 2000) reduced unemployment to 7.6 percent from rates exceeding 14 percent in the early-1990s.

Table 1: Key Macroeconomic Indicators: 1990-2001

	1990	1993	1995	1996	1997	1998	1999	2000	2001
Annual GDP Growth (% change)	6.4	6.9	5.5	3.8	6.3	4.7	4.3	6.0	-1.4
Atlas GNP Per Capita (US\$)	470	600	700	750	800	810	820	850	830
Annual Change in (Colombo) Consumer Price Index	21.5	11.7	7.7	15.9	9.6	9.4	4.7	6.2	14.2
Investment/GDP Ratio	22.2	25.6	25.7	24.2	24.4	25.1	27.3	28.0	22.0
Domestic Savings/GDP Ratio	14.3	16.0	15.3	15.3	17.3	19.1	19.5	17.2	14.6
C/A Balance (excluding official transfers) (% of GDP)	-5.4	-5.3	-6.5	-4.9	-2.6	-1.4	-3.7	-6.6	-1.9
Overall BOP Surplus/Deficit (in US\$ million)	119	661	52	-68	163	37	-259	-522	220
Gross Official Reserves (in months of imports of GNFS)	1.7	4.5	4.1	3.8	3.5	3.3	2.2	1.5	2.0
External Debt Service Ratio (% of GNFS)	17.8	12.9	16.5	15.3	13.3	13.3	15.2	14.7	13.3
Government Revenue (% of GDP)	21.1	19.7	20.4	19.0	18.5	17.2	17.7	16.8	16.5
Government Current Expenditure (% of GDP)	22.3	20.5	23.5	22.8	20.8	19.6	18.7	20.2	21.4
Interest Payments (% of GDP)	6.4	6.0	6.2	6.4	6.2	5.4	5.6	5.7	6.7
Government Capital Expenditures (% of GDP)	6.1	6.7	5.9	4.9	4.9	5.3	5.5	5.4	4.8
Budget Deficit (% of GDP) ^{1/}	-9.9	-8.7	-10.1	-9.4	-7.9	-9.2	-7.5	-9.9	-10.9
Primary Deficit (% of GDP)	-3.5	-2.7	-3.9	-3.0	-1.7	-3.8	-1.9	-4.2	-4.1
Government Debt (% of GDP)	96.5	96.9	95.2	93.1	85.9	90.8	95.1	96.8	103.6
Of which Domestic Debt (% of GDP)	41.6	42.8	43.3	46.4	43.6	45.5	49.1	53.8	58.3
Government Employment (thousand persons)	649	-	738	752	762	790	822	857	864
Nominal Average Exchange Rate (Rs./US\$)	40.1	48.3	51.3	55.3	59.0	64.6	70.4	77.0	89.4

^{1/} Excluding grants and privatization proceeds.

Sources: Central Bank of Sri Lanka and Department of Census and Statistics.

13. Sri Lanka has many strengths, including leading developing countries in recognizing the importance of education, health and gender equality for development. These, together with one of the most open trade and foreign direct investment (FDI) regimes in South Asia, have fostered healthy manufacturing production and export performance, especially in tea and textiles. With the successful privatization of the plantation sector, Sri Lanka has recaptured its position as the world's largest tea exporter. Benefiting from the liberalization of banking and telecommunications and, until 2001, the expansion of tourism and container traffic, the service sector has grown steadily. Nevertheless, slow progress in key structural areas—including civil service reform, restructuring state-owned enterprises (SOEs), and financial, land and labor market reform—have undermined potential growth and slowed progress towards reducing poverty.

14. The fiscal situation was an increasing concern throughout the 1990s, with the deficit (before grants) remaining between 7-11 percent of GDP and revenue performance weakening by about 4 percentage points of GDP since 1995. The escalation of the conflict in the late-1990s and the continuing expansion of public sector employment compromised expenditure adjustments. Heavy reliance on domestic deficit financing—averaging 75 percent of financing needs since 1996—have made interest payments one of the largest budget expenditure items, amounting to 6.7 percent of GDP and over 40 percent of tax revenue in 2001. Hence, important expenditure categories—such as physical and social infrastructure—have been crowded out and public debt climbed to over 100 percent of GDP in 2001.

15. Sri Lanka suffered significant economic setbacks in 2001. The change to a floating exchange rate regime on January 23 was an important step to stem the loss of external reserves that had started in 2000. However, given import demand pressures and high oil prices, by March 31 gross official reserves fell to under 2 months of import financing needs. To improve fiscal balances, stabilize the exchange rate and reverse reserve losses, the Government entered into a Stand-By Arrangement (SBA) with the International Monetary Fund (IMF) on April 20⁴. However, adverse political and economic developments in the second half of 2001—including the July 24th attack by the LTTE on the Colombo international airport, sluggish external demand, the prolonged drought and the general political uncertainty—contributed to derailing the program⁵. With these shocks, output declined by 1.4 percent in 2001—the first contraction since independence in 1948. In addition, defense spending over-runs and fiscal laxity intensified in the run up to the December 2001 elections.

16. In 2002, Sri Lanka began to experience a gradual recovery. The Government presented a strong budget in March demonstrating their commitment to growth, fiscal consolidation and structural reform. To this end, the goods and services tax (GST) and national security levy (NSL) were transformed into a value added tax (VAT), selective expenditure cuts were introduced (including a credible public sector hiring freeze), restrictions on FDI were further relaxed and the deficit target was set at 8.5 percent of GDP⁶. The measures have fostered investor confidence, boosted the stock market and doubled capital inflows on a cumulative basis. With the return of normal rains and the cessation of hostilities, GDP growth turned positive in the first quarter of 2002 and is estimated at about 3 percent for the year, largely reflecting a pick-up in domestic-oriented activity since global demand remains sluggish. The 2003 budget presented on November 6, 2002 maintains continuity of the earlier initiatives.

⁴ For more information on the IMF program in Sri Lanka, see the "Fund Relations Note" in Appendix II.

⁵ The program was subsequently brought back on track and the IMF released the last tranche under the SBA in September 2002.

⁶ The estimated 2002 budget deficit of 9 percent is primarily due to less than expected GDP growth and VAT exemptions intended to contain upward pressures on the cost of living.

D. Medium-Term Macroeconomic Prospects

17. Looking ahead, Sri Lanka has a good opportunity to restore macroeconomic stability and achieve economic performance commensurate with its human and natural resources. Its medium-term prospects for increased GDP growth and sustained fiscal and external sustainability have recently improved due to: (i) the positive developments in the peace process; and (ii) the continued implementation of a credible program of macroeconomic stabilization and structural reforms. A growth-focused program is being implemented to liberalize factor markets, increase agriculture productivity, restructure SOEs, strengthen the commercial legal foundations, implement a stable import tariff regime and increase private sector participation in infrastructure. Furthermore, steps are being taken to strengthen tax administration and fiscal discipline, as well as to refocus the Central Bank of Sri Lanka (CBSL) to its primary task of price stability. A healthy economic revival should result from these developments, along with improving investor sentiments, expected reconstruction activities in the North East, improvements in the power supply and recovery in agriculture and services.

18. If peace holds and the stabilization/structural reform program stays on track, Sri Lanka can achieve 5-7 percent GDP growth with single-digit inflation in the medium-term (see Table 2)⁷. Regarding the fiscal outlook, sustained implementation of the reform program, together with higher GDP growth, should lead to gradual reduction of the budget deficit and public debt. This would also create increasingly more fiscal space for high priority poverty programs. In an environment of price and political stability, business and household formal savings would be encouraged; hence, leading to an increase in the national savings rate.

Table 2: Medium-Term Macroeconomic Projections: 2002-2006
(In percent of GDP or as noted)

	2002 ^{a/}	2003	2004	2005	2006
Annual GDP Growth (% change)	3.3	5.5	6.5	6.8	7.0
Average Inflation (% change)	9.6	8.9	7.0	6.0	5.0
Gross Investment/GDP Ratio	22.3	24.2	26.3	27.9	29.0
National Savings/GDP Ratio	20.3	20.8	22.1	23.7	25.3
C/A Balance (including official transfers)	-1.8	-3.3	-4.1	-4.1	-3.6
Overall BOP Surplus/Deficit	1.5	0.1	0.4	0.5	0.9
Gross Official Reserves (in months of imports of GNFS)	2.4	2.7	3.1	3.4	3.6
Total External Debt	59.6	58.7	58.2	57.7	55.6
Government Revenue	16.5	16.9	17.9	18.7	19.1
Government Current Expenditure	20.8	19.2	17.9	16.8	16.2
Interest Payments	7.4	7.3	6.6	5.9	5.5
Government Capital Expenditures	4.6	5.2	6.2	6.9	7.2
Budget Deficit ^{1/}	-8.9	-7.5	-6.3	-5.1	-4.3
Primary Deficit	-1.4	-0.2	0.3	0.8	1.2
Net External Financing	0.1	2.0	3.0	3.2	2.7
Grants	0.4	0.4	0.6	0.6	0.6
Government Debt (% of GDP)	103.8	99.6	94.5	89.1	83.8
Of which Domestic Debt (% of GDP)	60.0	56.8	52.2	47.2	42.8

^{a/} Provisional.

^{1/} Excluding grants and privatization proceeds.

Source: Ministry of Finance, Central Bank of Sri Lanka and staff estimates.

⁷ The growth projections are consistent with the PRS discussed below. They also take into account the likely adverse impacts of the elimination of MFA quotas by end-2004.

II. REGAINING SRI LANKA AND CONNECTING TO GROWTH: SRI LANKA'S POVERTY REDUCTION STRATEGY

A. Background

19. During the past four years, the administration has engaged in broad stakeholder consultations to reach consensus on a medium- to long-term strategy for faster and sustained economic development and poverty reduction. The incidence and depth of poverty were widely discussed, along with the country's approach to the problem. The island-wide consultative process also mobilized views of key stakeholders on how to work together on relief and rehabilitation in the conflict-affected areas through the *Framework for Relief, Rehabilitation, and Reconciliation (RRR)*. The results of these consensus-building consultations together with background assessments resulted in a well-developed draft of Sri Lanka's Poverty Reduction Strategy (PRS), which development partners strongly endorsed at the June 2002 Development Forum.

20. After its election, the new Government set about the task of defining its own economic and poverty reduction program—*Regaining Sri Lanka: Vision and Strategy for Accelerated Development (RSL)*—more precisely⁸. This is an aggressive proposal to eliminate factors which inhibit the restraints on private sector activity and change the role of the state, while addressing the key elements of poverty. The main objective of the PRS is to “regain Sri Lanka” by accelerating growth and eliminating poverty through private sector-led development. This marks a fundamental departure from the previous unsustainable policies of “redistribution and transfer” to alleviate poverty. To meet its objectives, the PRS outlines six core areas:

- Building a supportive macroeconomic environment;
- Reducing conflict-related poverty;
- Creating opportunities for pro-poor growth;
- Investing in people;
- Empowering the poor and strengthening governance; and
- Implementing an effective monitoring and evaluation system.

21. The PRS identifies halving the number of poor by 2015 as its key target. Other targets include: (i) raising GDP growth to around 7 percent within three to four years and to 10 percent in the second half of the decade; and (ii) creating a minimum of two million new jobs during the next few years. For each of the key PRS elements, recently implemented actions/reforms are identified and specific actions to be implemented over the medium-term are outlined and prioritized (see Annex B10).

B. Building a Supportive Macroeconomic Environment

22. Creating the conditions for accelerating economic growth with macroeconomic stability is a top priority of the PRS. Sri Lanka has not been able to achieve economic growth consistent with its human and natural resource endowments. In part, this below potential performance has been due to the conflict, however, there is also a need to remove distortions in the economy and reform the enabling environment to foster private sector development. The PRS identifies highly inflexible labor laws, constraints on land transfers and sizes, inadequate infrastructure, a large/inefficient SOE sector, bureaucracy and a serious bottleneck in tertiary education as key factors contributing to a high cost of doing business. Further, it proposes to address a variety of legal, institutional and regulatory impediments which hamper private sector activity.

⁸

RSL was officially released in January 2003 and may be obtained at www.regainingsrilanka.org.

23. Recognizing that macroeconomic stability is a *sine qua non* for sustained high economic growth, strong emphasis has also been placed on fiscal sustainability and strengthening the macroeconomic framework. Significant reductions in the budget deficit and public debt are planned to restore fiscal sustainability and strengthen macroeconomic stability. Currently, interest payments, the salary/wage bill, defense spending and subsidies/transfers account for most of the budgetary expenditures, leaving small amounts for capital expenditures—less than 5 percent of GDP—and negligible amounts for non-wage repairs/maintenance. The medium-term objective is to reduce the budget deficit to 5 percent of GDP by 2005 and public debt to below 90 percent of GDP. Aside from the fiscal measures, some of the structural reforms initiated under the program—i.e., those pertaining to SOEs and administered prices—will contribute to the fiscal consolidation and deficit/debt reduction effort. To ensure that fiscal discipline is maintained and fiscal consolidation continues, the Government recently enacted the Fiscal Management Responsibility Act, which requires regular reporting on the budget and also mandates a “Pre-election Budgetary Position” report to discourage pre-election hand-outs. The Act also sets strict limits on borrowing from the Central Bank and fixes the 2006 budget deficit target at below 5 percent of GDP.

24. In the PRS, domestic economic liberalization and strengthening the enabling environment are seen as key to fostering private sector-led growth. Emphasis has been placed on reforming factor markets; most notably, labor, land and financial (see Box 3). Recently amendments were passed to increase flexibility in the labor market, thereby enhancing labor mobility, productivity and employment generation⁹. For a more efficiently functioning land market, preparations are underway to clarify property rights and modernize the institutional framework. Efforts are being made to establish a legal framework to remove restrictions related to the sale, leasing, transfer and mortgaging of rural lands previously distributed to farmers. It is also likely that state-owned urban land will be divested to raise resources and promote more efficient use of urban land.

Box 3: Constraints in the Labor and Land Markets

Well-functioning labor and land markets are pre-requisites for economic growth, but currently in Sri Lanka there are constraints in both which inhibit development.

In **labor**, formal workers are protected by laws such as the Termination of Employment of Workmen Act (TEWA, 1971) and the Industrial Disputes Act (1950). Under TEWA (applying to private sector firms with 15 or more employees), the termination of any worker is only possible with the prior written consent of the Commissioner of Labor or the employee concerned. The Commissioner has the discretion to accept or reject a firm’s application and has the prerogative to determine the exact compensation to be paid. As such, smaller firms have no incentive to graduate and larger firms are reluctant to hire additional workers.

The majority of **land** in Sri Lanka is state-owned and controlled, but farmed by private farmers under varying tenure arrangements most of which permit private use and inheritance, but restrict lease and sale. The Land Reform Act (1970) nationalized private land holdings in excess of 50 acres and redistributed them to small-holder tenants in perpetuity, placing a ceiling on tenant farms of five acres. Furthermore, the deeds registration system places cumbersome burdens on private land owners in the rural sector and private lands are also affected by land use restrictions—e.g., the Paddy Lands Act does not allow paddy land to be used for non-paddy cultivation without Government permission. All these factors together impede the efficient use of land.

25. The PRS aims to improve financial intermediation by restructuring the state-owned banks—the Bank of Ceylon (BOC) and People’s Bank (PB) account for over 50 percent of banking sector assets—increasing private sector participation in the insurance and pension fund industry and strengthening the regulatory and supervisory framework in financial markets. To improve the enabling environment for private activity, steps will be taken to: (i) move towards a uniform/lower and transparent corporate tax

⁹ These amendments—not yet effective—require the Labor Commissioner to apply a new compensation formula for job termination cases and expedite redundancy/labor dispute-related hearings and determinations according to a time-bound labor dispute settlement rule.

structure; (ii) modernize the legal/regulatory environment for market entry and exit; (iii) establish a modern, unified tax administration; and (iv) reduce and rationalize tariff protection.

26. Sri Lanka has a significant number of large SOEs involved in commercial activities, including utilities, transport, banking, petroleum and the wholesale of basic commodities. The PRS concludes that these SOEs have been a drag on the economy and burden on the budget¹⁰, and have failed to deliver reliable and affordable goods and services. Consequently, the PRS proposes to continue the privatization program in most commercial activities, while undertaking restructuring of some of the large SOEs and encouraging private sector participation in infrastructure. For example, in petroleum some of the Ceylon Petroleum Corporation's (CPC) assets are being divested and steps are being taken to open importation, distribution and retail activities to the private sector. In power, legislation is proposed to: (i) unbundle generation, transmission and distribution; (ii) break-up Ceylon Electricity Board (CEB); and (iii) establish an independent regulatory body with responsibility for implementing economically sound tariff policy, regulating the sector and issuing licenses.

27. About 80 percent of Sri Lanka's population and 90 percent of the country's poor live in rural areas. Despite its declining contribution to GDP (20 percent in 2000), the agricultural sector (including livestock and fisheries) remains vital for employment and income generation. Thus, fostering rapid rural development—particularly raising productivity and competitiveness in agriculture and the non-farm rural sector—is critical for achieving faster overall economic growth and poverty reduction. As such, the PRS gives high priority to rural development and measures are being taken to remove policy/institutional constraints, including the on-going reforms in labor and land administration and policy. Other key elements of the rural development strategy include: (i) rationalizing the trade regime for agricultural outputs, inputs and technology; (ii) gradually reducing state involvement in agricultural marketing; and (iii) supporting improvements in rural infrastructure—i.e., roads, electricity, communications and water and sanitation—to facilitate connectivity and integration.

C. *Reducing Conflict-Related Poverty*

28. As indicated, Sri Lanka's protracted conflict has resulted in a significant humanitarian problem. Establishing lasting peace is viewed as the key to reducing conflict-related poverty and as such, a critical element of Sri Lanka's PRS. To this end, the Government is pursuing a three-pronged approach consisting of: (i) negotiating a political settlement; (ii) enacting constitutional reforms to fulfill the aspirations of all citizens; and (iii) expediting development in the conflict-affected areas (see Box 4). The RRR Framework will help to address the basic needs of the people affected by the conflict, improve conditions for the resumption of economic activities and facilitate ethnic reconciliation. The Government has been actively engaged with donors to mobilize

Box 4: The Bank's Activities in the North East

Since 1999, the Bank has been a leader in assisting development of to the North East (NE). The NE Irrigated Agriculture Project (NEIAP; 1999) has been active in conflict-affected areas supporting community-driven efforts to rebuild economic activity and the 2001 Land Mine Action Project (a US\$1 million Post Conflict Fund Grant administered by UNDP) has been supporting de-mining activities. In mid-2002, the Bank developed a three-phase strategy for comprehensive reconstruction support to the NE. In the first phase, we are redirecting, expediting, and scaling-up activities in the NE in those projects which focus on the entire country, but activities could not be carried out in the NE because of the conflict. Approximately US\$15 million was identified through four projects. In the second phase, certain projects—with significant savings and/or where project components will not meet development objectives by closing—have been restructured to provide additional urgently needed support to the reconstruction efforts. US\$31 million was identified in three operations and a restructuring package was approved by the Board on November 14, 2002. In the third phase, a longer-term program to meet the development needs of the NE is being addressed in the context of this CAS. In addition, the Bank will administer the North East Reconstruction Fund (NERF)—the main vehicle for implementing humanitarian and rehabilitation programs in the NE.

¹⁰ SOE losses equaled 1.5 percent of GDP in 2000 and budgetary (recurrent and capital) transfers to SOEs amounted to 3 percent of GDP in 2001.

financial support for immediate humanitarian and rehabilitation needs in the North East. A donor conference was held in Oslo on November 25, 2002 and will be followed by an international donor meeting in Tokyo on June 9-10, 2003.

D. Creating Opportunities for Pro-Poor Growth

29. Another priority of the PRS is to effectively connect poor regions to rapidly growing domestic and international markets. The strategy focuses on six main pro-poor transport and communications initiatives, specifically: (i) upgrading the port network; (ii) building a national highway system and integrated road network; (iii) enhancing performance of the bus system; (iv) modernizing the railways; (v) improving access to telecommunications facilities; and (vi) bringing internet into the countryside. The strategy in this area is to introduce public-private partnerships to expand the scope for investment and provide a wider range of services—especially in areas such as energy, ports, water supply and transport—to the public.

E. Investing in People

30. Improving access to quality education and basic health services is central to the PRS and the strategy promotes a growing private sector role in their provision. In education, the focus will be on: (i) addressing regional inequities in the provision of quality basic education; (ii) improving the curricula in secondary education; and (iii) enhancing the relevance of tertiary education in line with market needs, including increasing capacity by opening up to the private sector. In health/nutrition, the goals are to: (i) improve the nutritional status of infants, children and pregnant women; (ii) maintain a low incidence of non-communicable diseases; (iii) reduce the burden of vector-borne diseases, including malaria; and (iv) fight AIDS. The overall objective is to improve the equity, efficiency and effectiveness of health expenditures and the main focus will be on preventive health care programs and encouraging the private sector to develop secondary and tertiary care private hospitals. Capitalizing on Sri Lanka's long-standing strengths in social mobilization, there will be reliance on community-based organizations (CBOs) to expand the provision of safe drinking water and sanitation services in rural areas under a sustainable system of tariff setting and maintenance. In urban areas, the private sector will be encouraged to play an increasing role in these activities.

F. Empowering the Poor and Strengthening Governance

31. Another thrust of the PRS is to change the role of the state from being a “provider” of goods and services to being a “facilitator” of private sector activity. As such, there is commitment to reducing state involvement in commercial activities and focus on primary activities and responsibilities in providing public goods/services and using public resources more effectively for poverty reduction. To this end, there is a need to: (i) reform public administration; (ii) improve transparency and accountability; and (iii) continue decentralization. As mentioned, public expenditure management needs to be strengthened, including expenditure planning/budgeting, execution, monitoring/control and oversight. At the same time, to empower the poor, the intention is to shift the focus of authority from the central to local Governments. Efforts will be placed on strengthening the management capacities of local Governments to ensure that they play a more effective role in meeting locally-defined initiatives and discharging devolved responsibilities.

G. Assessment of the PRS

32. As indicated in the Bank/IMF Joint Staff Assessment (JSA), Sri Lanka's Poverty Reduction Strategy is broadly appropriate for addressing the country's current economic development and poverty reduction challenges and provides a sound foundation for the Bank's assistance. The PRS candidly lists

the causes of poverty. Aside from the civil conflict, it correctly identifies the highly restrictive controls/regulations that have inhibited the functioning of the domestic factor markets and rural economy as principal causes of Sri Lanka's below potential performance. It acknowledges that the heavy involvement of the state in commercial activities has constrained private sector development and economic growth. Particularly important is the recognition that the policy of redistribution/transfers pursued so far to reduce poverty has been ineffective. As mentioned, the PRS envisions a role for the state as that of: (i) facilitator of an enabling environment for private sector-led growth; and (ii) creating opportunities for the poor to participate in the growth process. The latter is to be achieved through greater public expenditure devoted to human resource development and infrastructure. The PRS also calls for smaller and better targeted safety net programs. Given the large public debt and the tight fiscal situation, the PRS correctly indicates that the pace at which the reform agenda can be implemented depends on the fiscal space that can be created by economic growth, the restoration of peace, macroeconomic stability and concessional assistance.

33. This said, the JSA points out a number of areas in which the PRS could be strengthened; specifically:

- There is nothing with regard to institutionalizing a public sector tracking system;
- Although there is a comprehensive picture of the patterns and determinants of poverty, further work is warranted to monitor and assess the impact of current and future fiscal policies on the poor;
- The poverty diagnostics for the North East is inadequate and needs to be improved; and
- There is a need to enhance institutional arrangements to coordinate monitoring and evaluation and promote incentives for its use in policy and budgetary decision-making.

34. These all underscore the tremendous capacity building needs in the country, especially as they relate to measuring, analyzing, monitoring and evaluating poverty reduction outcomes. It is recommended that the first annual progress report of the PRS include: (i) an update of the macroeconomic framework and prioritization of policies aligned to a detailed costing of the PRS agenda; (ii) addressing critical issues in the governance agenda, especially in civil service reform, transparency and decentralization; (iii) a selection of indicators and baselines to monitor PRS implementation and setting up an expenditure tracking system; (iv) a preliminary assessment of the impact of policies on the poor and disadvantaged groups; and (v) completing the poverty assessment and reconstruction needs of the North and East.

III. THE BANK GROUP'S COUNTRY ASSISTANCE STRATEGY

A. *The Bank Group's Country Assistance Strategy for FY03-FY06*

35. The CAS program is built on the Poverty Reduction Strategy contained in *Regaining Sri Lanka: Vision and Strategy for Accelerated Development*. Within this, the Bank will focus on three core themes: **Peace, Growth and Equity**. Without peace, there is no prospect for development. This derives not only from the difficulty of creating a framework for sustainable poverty reduction and growth in such a situation, but also that the fiscal burden would likely become increasingly intolerable, and the most vulnerable of the poor in today's society—the conflict-affected and displaced populations—would not be reached. Growth is the key to prosperity and to creating more resources for distribution. The *Regaining Sri Lanka* strategy is the Government's response to the poor recent growth performance, and answers one of the Bank's key concerns over the earlier drafts of the PRS. Equity concerns will remain high in Sri Lanka, not only to permit the expected attainment of the MDGs, but more to ensure balance within the society. Education and health have made great strides, but access varies sharply across the country and

quality is a major concern. Furthermore, the South faces many natural disadvantages and growth has lagged behind other parts of the country. The explicit links between the PRS core areas and the CAS priority outcomes by theme are contained in Table 3.

Table 3: PRS Core Areas and Priority CAS Outcomes		
PEACE	GROWTH	EQUITY
Building a supportive macroeconomic environment		
	<ul style="list-style-type: none"> • Results-based budgeting system established • Legal framework established to increase flexibility in labor markets • Legal framework established to increase flexibility in land markets • Regulatory framework conducive to private sector participation established • <i>Time required and formal cost of business start-up reduced</i> • Agricultural producers receiving consistent price signals and clearer land titles 	
Reducing conflict-related poverty		
<ul style="list-style-type: none"> • Technical capacity increased at district and provincial levels to implement reconstruction program • Access to affordable health care expanded in conflict-affected areas • Education facilities restored in the conflict-affected areas to pre-war levels • Water supply for irrigation increased in conflict-affected areas 		
Creating opportunities for pro-poor growth		
		<ul style="list-style-type: none"> • Rural access to safe water and sanitation expanded
Investing in people		
		<ul style="list-style-type: none"> • Investment in education increased, especially in poor areas • Performance-based funding mechanism established at tertiary level • Effectiveness in use of health sector resources improved • <i>Overall coverage rate of measles immunization increased</i>
Empowering the poor and strengthening governance		
		<ul style="list-style-type: none"> • Number of empowered communities implementing sub-projects contained in their development plans expanded

Notes: Items in *italics* are IDA 13 targets. For a complete presentation of the outcomes framework, see Annex B11. The outcomes are closely linked to the PRS matrix and have been selected as Bank focus areas in consultation with the Government. The indicators and logic behind the indicators will continue to be refined in the initial CAS implementation phases.

36. In designing the CAS program, wide consultations have been undertaken both within and outside the Bank (see Appendix IV). The CAS is explicitly drawn on the fact that Sri Lanka is a post-conflict country, and thus incorporates three key conclusions from the experience of such countries:

- There is a strong case for increased assistance in the period following the end of hostilities, although the maximum impact is likely to be felt two to four years after such a cessation;
- There are good prospects for addressing key economic and social reforms in such a situation, even those that have proven difficult in the past; and
- The highest returns may be found in social aspects of development.

37. The CAS has been drawn up as a Bank Group strategy with the full participation of IFC. As will be seen below, there could be substantial synergies between the different arms of the Bank Group. In addition, an important cross-cutting theme of the CAS is capacity building. First of all, for the conflict-affected areas to “catch up” with the rest of the country, strengthening capacity in the region is as important as the physical reconstruction efforts. Furthermore, given the finalization of the PRS and results-orientation of the CAS, there is a critical need to focus on building capacity both for successful program implementation, as well as for effective monitoring and evaluation. While the World Bank Institute (WBI) will play a leading role in these efforts, strengthening institutional capacity is an important element in many IDA lending and non-lending activities.

Peace

38. As mentioned, peace is the very basis for the future of the Sri Lankan economy and for balanced poverty reduction. The key outcomes that the CAS is designed to support (see Table 3) include: (i) restored infrastructure in health, education and irrigation; and (ii) technical capacity built to implement the reconstruction and poverty reduction efforts.

39. There is a huge need for reconstruction and capacity building and to address the fiscal support needs generated by the peace process. It is important that the population begins to see the gains from peace at an early stage and that resources are in place to permit resettlement to occur. The Bank has already begun this process with the *restructuring of the portfolio*, which was approved by the Board on November 14, 2002. This restructuring affected seven on-going projects and mobilized US\$46 million in extra resources for the North and East, some 17 percent of our undisbursed portfolio. In total approximately US\$62 million—or over 25 percent of the existing undisbursed portfolio—will be available for this region of the country. The restructuring provides resources for health, water supply, capacity building, connectivity, and payments to returning IDPs, in what is referred to as the *North East Emergency Reconstruction Program*. This supplements the on-going work in community development and irrigated agriculture (through NEIAP), education, the legal system and environment. Furthermore, the Bank will contribute to the reconciliation effort in particular through the on-going education projects by assisting the Government in its strategy to: (i) develop English as a way to eliminate language-based segregation, while encouraging Sinhalese and Tamil as “second” languages—i.e., native Sinhalese speakers to learn Tamil and native Tamil speakers to learn Sinhalese; and (ii) formulate curricula, textbooks and pedagogic approaches that foster pluralism, tolerance and social cohesion.

40. In addition, the North and East have been starved of investment for the past 20 years. Poverty levels are unknown, but appear to be among the highest in the country. After the immediate reconstruction, there is 20 years of deferred maintenance and postponed investment that will need to be addressed. It is likely that many development partners will be willing to participate in these efforts. The Bank will work with these partners, both on the planned needs assessment in FY03¹¹, and also in the design and implementation of further support programs for infrastructure and for capacity building. Many donors are willing to increase their assistance to Sri Lanka in the short-term to support

¹¹ The Bank is leading the efforts in preparing the housing needs assessment and is working closely with UNICEF on education, as well as co-financing the team leader with UNDP. The needs assessments will provide background for the June 2003 Tokyo Financing Conference for Sri Lanka.

reconstruction and rehabilitation. For this purpose, the *North East Reconstruction Fund (NERF)* has been created and the Bank will act as its administrator. In the Bank's lending program, a Credit for *Infrastructure Rehabilitation and Capacity Building in the NE* is proposed for early-FY05, but its size and timing would be determined to a significant degree by absorptive capacity issues and by the level and timing of commitments from other development partners. This operation would be flexible, and thus able to respond to a variety of needs in infrastructure, capacity and perhaps in land management, with the Bank acting as the "lender of last resort". A key feature would be to utilize such an operation to encourage the local private sector, especially in the area of contracting.

41. An issue that has not yet been addressed is that of disarmament, demobilization and reintegration (DDR) of combatants. The two sides are not yet ready to discuss demobilization, and thus it is difficult to assess whether it will be necessary for the Bank to consider a role in this regard. Initial discussions in partnership with the International Labor Organization (ILO) have taken place and this will be kept under close review.

Growth

42. At the core of RSL/PRS is the desire to raise the rate of growth and to rejuvenate the private sector by removing the policy constraints that are inhibiting the achievement of these objectives. The CAS strongly supports the Government's view that it is imperative that the peace process be accompanied by an equally determined economic reform process to unleash the strong potential of the economy. As such, the key CAS outcomes (see Table 3) to be achieved include: (i) legal frameworks established to increase flexibility in the labor and land markets; (ii) a regulatory environment conducive to private sector participation established; (iii) the time and formal cost of business start-up reduced; and (iv) agricultural producers receiving more consistent price signals and clearer land title.

43. A key component of any poverty reduction and growth scenario for Sri Lanka must be a sound macroeconomic environment. As mentioned, the conflict has resulted in high fiscal deficits, leading to an accumulation of over 100 percent of GDP in public debt and domestic debt of 58 percent of GDP. Restoration of fiscal stability is at the center of the macroeconomic program to be supported by the IMF Poverty Reduction and Growth Facility (PRGF)—an important basis for the Bank-supported program.

44. In FY03, the Bank's initial support to this process will come through the *Economic Reform Technical Assistance Project* which was presented to the Board on December 10, 2002. This will provide the technical support that is needed to implement the ambitious program. It is designed to be flexible, in order to be able to respond to reform opportunities as they emerge. An initial group of reform areas—including financial sector, utilities and regulatory capacity building—have been identified, but the allocation of the majority of funds will be determined over the next three to four years and will likely include assistance to prepare a public sector reform program. As mentioned below (see paragraph 65), this project will also support capacity building efforts to strengthen the country's poverty monitoring and evaluation ability. This project accompanies the on-going *Legal and Judicial Reform* which is supporting the modernization of the legal system, especially as it impacts on the private sector, and with a special emphasis on improving the quality of judicial services. A particular focus is access to justice for women and for the citizens of the North East through a Japan Social Development Fund (JSDF) grant.

45. The completed PRS provides the basis to proceed with *Poverty Reduction Support Credits (PRSCs)* in Sri Lanka. Annual PRSCs would provide budgetary support to assist in the implementation of the PRS, not least to permit government to provide public services in previously unserved areas. At the heart of the PRS is a program to release the private sector from its constraints, and to reorient public expenditure away from a welfare and control mentality towards an empowerment and service provision approach. While the PRSCs would review the overall progress in the implementation of the PRS

program, there would also be an annual focus on particular areas of the strategy where deeper progress would be targeted. In the first of these—planned for FY03—the focus would be on factors of production: finance, labor, land and utilities; the elements of the PRS described in paragraphs 24-26 above¹².

46. The financial sector has received a lot of past Bank attention, with an on-going operation to support the strengthening of the Central Bank and a recently-completed Financial Sector Assessment Program (FSAP). Following up on vulnerabilities revealed in the FSAP with regard to anti-money laundering and counter-terrorism financing, in the coming years the Bank will provide technical assistance for capacity building and formulation/implementation of an appropriate legal framework. Nevertheless, the primary obstacle to the healthy development of the financial sector remains the dominance of the state banking system, whose reform would be central to this program. Labor markets have long been identified as a major constraint to investment, and the program would focus on improving certainty for employers in such areas as the costs and timing of redundancy, while improving the functioning of the market itself through better information centers. Land markets are to be improved through converting restricted land grants to freehold so that farmers can more readily sell, lease or use their land as collateral. The reform of the power and telecommunications sectors calls for greater regulatory capacity and a change in the role of the state, and this too would form a part of the early program to be supported. Last and by no means least, the first year of implementation of the PRS would see a strong emphasis of monitoring and evaluation mechanisms for the PRS itself through various capacity building efforts. In this regard, lack of a medium-term expenditure framework (MTEF) has made the costing of PRS initiatives difficult. The development of a MTEF—aided by public expenditure analysis—which the Government plans to have in place by mid-2003, is key to a more in-depth costing of the PRS, thereby helping to undertake pro-poor budget allocations over time, and the Bank will provide any necessary support for this effort.

47. The second PRSC would be in FY04 and might focus on two key areas for the poverty agenda—the *reform of the welfare system* into one which is much more tightly focused on those in need, and *reform of the rural economy*, in particular to raise the productivity of farmers, who remain the poorest sector of the economy. The greatest challenge in this regard is to de-politicize and improve the targeting of Samurdhi—largely a cash transfer program—based on the recently enacted Welfare Reform Act that sets objective criteria for selection of beneficiaries through means-testing and tracking. These reforms are expected to engender better targeting with lower exclusion of deserving beneficiaries. In the third PRSC—in FY05—attention would turn to the public sector itself, with a focus on the reform of public sector employment systems and structures, and the related structure of public expenditure, including the issues of decentralization of decision-making and revenue-sharing. It is likely that the implementation of this *public sector reform* would need to be accompanied by a *Technical Assistance Credit* to support the complex technical work associated with public sector restructuring (including retraining re-deployed staff) and developing a comprehensive program for strengthening public sector capacity. If this reform program is ready sooner it could be incorporated into the second PRSC. The specific theme of the fourth PRSC in FY06 would be determined on the basis of the outcome of the *Development Policy Review* (DPR), but could well focus on the management and efficiency of public expenditure.

48. To accompany this work, a continuous program of *Public Expenditure Review* (PER) work is planned, again with annual themes. Rather than producing a large report, this work would result in

¹²

Obviously, the reforms receiving “focus” in each of the PRSCs will not be completed in a single year, but will take time for complete implementation—e.g., the land and labor reforms highlighted in the first PRSC. When a reform is a “focus” area in one PRSC, it is likely that additional milestones to “cement” the reform will be featured in subsequent PRSCs—i.e., as discussed in paragraph 47, labor and land issues also figure prominently in reforming the rural economy, and therefore, follow up actions in these areas will likely figure prominently in the second PRSC.

smaller outputs that can be incorporated into the living PRS as implementation proceeds¹³. This would complement and build on the work of the *Country Financial Accountability Assessment (CFAA)* and the *Country Procurement Assessment Review (CPAR)*—both to be completed in FY03¹⁴—and would form the basis for a future program of technical support to reform the fiduciary framework. These would be summarized in a *Safeguards Assessment Paper* that would also incorporate the current state of knowledge on Sri Lanka’s management of environmental and social safeguards, and would accompany the first PRSC to the Board.

49. While addressing the policy issues through budgetary and technical support can remove many of the constraints inhibiting the private sector, it is also important to contemplate the sources of growth. This will be addressed in part by two proposed non-lending pieces. The first of these would be an assessment of the *Investment Climate* carried out during 2003 and 2004 in cooperation with the Asian Development Bank (ADB) and the United Nations Development Program (UNDP). In addition to the standard work on the climate for “urban” investment, given the importance of encouraging off-farm employment opportunities in rural areas, this would incorporate a “rural investment climate” component. In addition, after the initial reform process has had a chance to eliminate the most obvious constraints, the Bank would conduct a *Development Policy Review*, with a particular focus on future sources of growth. It is clear that the economy will be going through major changes in the coming years, both because of the potential for new areas of growth and the likely decline of the garment industry after the end of the current Multi-Fibre Arrangement (MFA) in 2005. The PRS makes a start in this direction by outlining detailed action plans for raising productivity in priority sectors—i.e., agriculture, fisheries, tourism, apparel and the tea industry. However, the PRS does not analyze the links between these sectors and poverty-related outcomes, which is critical for prioritizing policies that promote pro-poor growth. It is also important to increase the availability of financing to support the growth of the private sector. IFC will take the lead role here, making direct investments in medium and large-scale companies and building the capacity of the financial sector to finance private enterprises—especially for small and medium enterprises (SMEs)—through investments and technical assistance.

50. One area that is considered by many to have significant potential for fostering growth both on its own and by raising productivity in other sectors is the *Information Communications Technology (ICT)* sector. This is an important focus of the Government’s development policy and the Bank would provide support to this effort in FY04—through *E-Lanka*—emphasizing the policy and regulatory environment, the development of e-government, rural connectivity and societal applications. There seems to be great potential for Sri Lanka to follow India as a major player in this market and this operation would be designed to help “jump start” this activity. A related operation would be the proposed *Improving Relevance and Quality of Undergraduate Education Project (IRQUE)*, which would both increase the supply of in-demand skills—such as those in Information Technology (IT)—while also equipping recent graduates with basic employment requirements, including English language skills. IFC will also consider investments in ICT companies.

51. Another issue that impacts on growth and also on the durability of the peace process and the achievement of equality of opportunity is *Land Administration and Policy*. It will be important to absorb the lessons of the Learning and Innovation Loan (LIL) currently under implementation and decide whether the experience justifies a “scaling up” into a major operation, that might include key aspects of

¹³ One particularly pressing issue to be covered by the PER work relates to the increased IDA lending volumes provided through program support and Sri Lanka’s potential near-term graduation from IDA concessional lending (see paragraph 88 below). Specifically, given the already high levels of debt servicing, in the near future this work will focus on helping Sri Lanka start to prepare—i.e., with regard to formulating a sustainable debt strategy—for the phasing out of large volumes of concessional financing.

¹⁴ See Appendix V for a summary of the findings of these reports.

land policy, not the least of which is the massive holdings of land by the Government in both urban and rural areas. This analysis would be done in FY05, and if a positive evaluation of the learning experience emerges, it could be followed by a scaled up project in FY06.

52. Without rural growth, the prospects for sustained poverty reduction are unclear. However, while land policy is a clear case, it is less clear how the Government proposes to address more general issues related to agriculture and rural development. For instance, while the PRS advocates private sector-driven productivity improvements, the action plan appears to advocate continued state interventions. The strategy would also benefit from refinements to address important systemic issues such as improving linkages between federal and provincial-level agencies and making lead institutions—such as the Department of Agriculture—more responsive to sector demands. Policy issues would be addressed through the PRSC framework, and the on-going Mahaweli project will continue to implement important pilot programs in areas such as bulk water and river basin management. The Government has asked that the Bank support the agricultural sector through lending. Based on recently completed work—Sri Lanka: Promoting Agricultural and Rural Non-Farm Sector Growth, Report No. 25387-CE, February 2003—and work contemplated for the future, should a reasonable proposal emerge, the program would be adjusted accordingly. Nevertheless, while there is a land management problem in the wet zone, there is a water management problem in the dry zone. If the pilots progress well and the on-going irrigation management reforms are completed, this could be followed by lending support later in the CAS period.

53. In the base case, IDA would not finance infrastructure. The two largest external providers of financing—the Japan Bank for International Cooperation (JBIC) and ADB—are willing to continue to finance the key programs in roads, energy and water supply. In the spirit of selectivity, IDA will participate only with respect to supporting key reforms and potentially private participation in infrastructure. If the Government does proceed with advanced reforms in areas such as urban water, railways, roads financing and ports, and succeeds in attracting private participation, in a high case scenario—in which these reforms are explicit triggers—IDA would consider participating through lending and/or guarantees. While generally limited to supporting cases where private financing would be attracted, one possible exception would be the highways sub-sector. Should the Government develop a viable Road Fund, the Bank would investigate participating through a sector-wide operation. Support for private infrastructure will be a top priority for IFC and is a primary area of potential synergy between IDA, IFC and MIGA, with scope for a creative combination of the instruments available to the three institutions if the policy environment is right. In the meantime, IFC will continue to look for investment opportunities in this area, beyond its existing investments in power, ports and mobile telecommunications.

Equity

54. While Sri Lanka has made remarkable strides in the area of human development over the last decades, serious equity issues remain—i.e., equality of opportunity and access to services. Access to and the quality of services in Sri Lanka differ greatly from one area to another. As such, equity issues are very important in a country where the resource base is not evenly distributed and where groups of citizens have been mired in poverty for a long time. Key CAS outcomes (see Table 3) focus on: (i) improved access to and quality of public services in education, health and water supply; and (ii) increased degree of empowerment of communities to address their own development needs.

55. As noted, a new household income and expenditure survey (HIES) is under way, which will include the North and East where many citizens suffer from conflict-related poverty. Once this new information is available, the Bank will work with the authorities to draw up a poverty map of Sri Lanka and collaboratively produce an *Updated Poverty Assessment*. This would start in FY04 and be finalized in FY05. While many policy reforms have been outlined in the PRS, a mechanism to monitor and assess

their impact is largely lacking. It is difficult to judge a priori whether these reforms will reduce poverty or have their intended impact. In this context, using the new national household data and other sources to analyze the poverty and social impact of reforms, as well as building similar capacity within Sri Lanka, remains a critical exercise for the future. This would be a focus of the Bank's contribution to the joint poverty work. Other early sector work would stress the *MDGs* and what is needed to attain these—and beyond—in Sri Lanka.

56. While the North and East suffer from conflict-related poverty, the South—notably Uva and Southern Province—suffers from structural poverty. The resource endowment of these areas is limited, water is scarce, distances are great and the human resource endowment is the lowest of those that are known. Under the on-going Mahaweli project, the Government has carried out community-driven development (CDD) pilots that have worked very well. NEIAP operates very successfully under similar principles and there are numerous other examples of this type of approach in Sri Lanka. Thus, the Ministry of Rural Economy has proposed that IDA undertake a *Rural Poverty Reduction Initiative*, under which poor communities in the South would be mobilized to analyze their key constraints—i.e., rural roads, water supply, income-generating activities, etc.—and resources provided directly to these communities to address those constraints. This process is one that would be scaled up gradually and would need support over a long period of time. An Adaptable Program Lending approach will be utilized, under which IDA would commit support in phases for 10-12 years, and the scope of the coverage would be gradually expanded from the South to include all the poorest parts of the country, including the estate/plantation sector. The results of the rural investment climate study will be useful for this operation. Nevertheless, one important service many rural communities place great emphasis on is water supply and a *Second Community Water* project has recently been negotiated¹⁵. It is envisaged that this operation will make a transition into a CDD approach over its lifetime, developing the locally-based expertise to support village level managed investments.

57. One of the key questions facing Sri Lanka with respect to access to services is the growth of urbanization and the related issue of *Services for the Urban Poor*. It is one of the key issues within the more general issue of decentralization, but with a set of rather specific features of its own. The Government has begun working to address urban policy issues and obviously the eventual outcome of the peace process—which will define more accurately the concept of “asymmetrical devolution”—will shape future policy in this regard in key ways. In preparation for a possible lending operation in FY06, a strategic options study, including fiscal decentralization issues, would be conducted in FY04. It is possible that CDD approaches would be adapted to the urban framework for an operation in this area.

58. In the sub-sectors related to equity concerns, it is very important that investment interventions be based on sound analytical frameworks. A *Health Sector Strategy* and program formulation exercise is under way, using a Policy and Human Resource Development (PHRD) grant. This would lead to the first proposed *sector-wide operation* for Sri Lanka in the *Health Sector* in FY04. This would supplement the *National HIV/AIDs Prevention* operation that was approved on December 17, 2002 and aims to build awareness of the risks of the pandemic, while improving capacity to address its most frequent manifestation in Sri Lanka, in tuberculosis¹⁶. The comprehensiveness of this sector-wide approach is expected to deepen over time, and one key area that is not being addressed with the current health sector

¹⁵ Given the severity of the poverty in the South and the CDD approach to be used, as well as the emphasis placed on water supply by rural communities, the Rural Poverty Reduction Initiative and the Second Community Water Project will be entirely financed by IDA grants.

¹⁶ Although mention of HIV/AIDs is made with regard to the health context, it is well-recognized that this issue is more appropriately an overall development issue. As such, an important aspect of the recently approved operation is to strengthen multi-sectoral involvement—i.e., the Ministries of Health, Defense, Labor, Education, Child Protection and Interior—and capacity on the fundamentals of HIV prevention.

work is that of **Nutrition**. Joint analytical work would be carried out, for later incorporation to the health sector program. Furthermore, IFC has already invested in a private hospital in Colombo and would continue to look for opportunities to support the private provision of health services.

59. Similarly, it has been agreed with the Ministry of Education that there would be a **Strategic Framework Exercise for the Education Sector** launched in 2004 and followed by a possible **Education Sector Operation** in FY05. Under this and the health sector operation, the Bank would provide financial support to the overall sector programs—essentially on a budgetary support basis—while ensuring appropriate expenditure frameworks to address key sectoral issues and constraints, with procurement and financial management arrangements that reassure all financiers—including most importantly the state—of sound resource use. In both sectors, it is especially important to use this opportunity to create capacity in the Ministries so that they can more strategically direct resources in the future, as well as more effectively monitor human resource development progress. Close work with the authorities would be undertaken to develop concrete action plans in areas such as decentralizing school management, promoting public-private partnerships and seeking private investment in training and technical education. Effective delivery of education services will also require defining the role of the provinces and devolved institutions in school administration and teacher deployment, in the context of the overall decentralization program. The previously mentioned **IRQUE** will focus on raising access to quality education at the tertiary level and making it more accessible to deserving students, thus supporting both growth and equity concerns.

Gender

60. While there is no freestanding program for gender activities proposed in this CAS, some operations do include a specific gender focus, such as the JSDF-supported program to encourage and expand women's rural financial institutions and networks. Rather, the approach is to ensure that in everything done by the Bank, the potential contribution of women is maximized in this country where women's roles are often discounted. For example, within CDD operations, efforts will be made to mobilize women's rural development societies—an approach that is already transforming villages in the North. In the HIV/AIDS program, women's groups will be empowered and sex workers—both women and boys—will be targeted for support. In the health sector, women's health issues and knowledge will be a major target of the program, not least in the area of nutrition. Finally, in terms of the program for the North East, there are many war widows who will receive particular support during the reconstruction and reconciliation process. In summary, the CAS does not propose a gender program; but instead proposes a program that will ensure that women's contributions to development are realized, since it is clear in Sri Lanka that whenever this happens the overall impact is significantly greater.

Safeguards

61. Similarly, in implementing the CAS, ensuring the Bank's safeguard policies will be crucial. Major work has recently been undertaken to review financial and procurement issues, with the completion of the CFAA and the CPAR (see Appendix V). Overall, financial management in Sri Lanka is quite good, but a major effort is needed with regard to the oversight aspects. Thus, the CFAA calls for particular attention to internal and external audit and to the role of Parliamentary Committees. In procurement, the issue is not adequate controls, but rather overlapping control systems that end up with a diffusion of responsibilities and with major delays to the procurement process. The CPAR calls for a simplification of the regulatory framework for procurement, possibly through a new procurement law.

62. A successful six-year program of support to environmental capacity-building is drawing to a close. Capability in the sector is quite high and awareness exceptionally so. Continued strengthening is needed—especially in the area of natural resources management—and will be primarily supported by a

new ADB-financed program. The high degree of collaboration between the Bank and ADB will continue in implementing this program, with the Bank serving on the project steering committee and Bank staff participating in ADB implementation efforts.

63. Finally, social development issues have come to the forefront, with significant resettlement of IDPs with Bank support and a major reconciliation program. As part of the IDP process, the resettlement regulations have been revised to a standard that meets the Bank's guidelines. Furthermore, the Bank plans to post a Post-Conflict Adviser for the South Asia Region in Colombo and a social development adviser is also being recruited. As mentioned, a note summarizing safeguard issues and assessing capacity will be submitted to the Board along with the first PRSC in FY03.

Summary of Outcomes

64. In preparing the CAS, the Bank's country team for Sri Lanka has developed a comprehensive country program results framework that links together the different levels of results—i.e., the country's longer-term development agenda based on the PRS/RSL and the shorter-term goals to be achieved during the CAS period and which are supported by the Bank's interventions (in partnership with other donors)¹⁷. The key priority base case "CAS Outcomes" have been summarized in Table 3 above.

65. Both the Government and the Bank realize that an effective monitoring and evaluation system is critical for tracking implementation of the PRS and hence, the CAS outcomes. There is much work ahead in data collection, analysis and its linkages with policy and the monitoring of inputs, outputs and outcomes. Particularly weak are the current institutional arrangements in Sri Lanka to coordinate the monitoring and evaluation efforts. An immediate challenge is to enhance the capacity of the Department of Census and Statistics to be able to conduct the key surveys—i.e., the HIES and the Consumer Finance and Socioeconomic Survey (CFSS)—required to deepen poverty diagnostics and monitoring at appropriate intervals. An integral part of poverty monitoring and impact is also the participatory component to assess access and consumer satisfaction with service delivery. During the initial phases of CAS implementation, the Bank will place specific emphasis on addressing these capacity constraints. As one example of how this will be done, the capacity of the Department of Census and Statistics will be enhanced in the context of the on-going Economic Reform Technical Assistance Project. Furthermore, the program of the WBI (see paragraphs 66-69 below) will also help to build monitoring and evaluation capacity. These and other efforts will clearly facilitate the monitoring of the CAS outcomes. At the time of the CAS Progress Report—i.e., two years from now—this particular aspect will receive special attention. It may be the case that CAS outcomes will need to be adapted in the light of experiences.

B. Bank Group Scenarios

Capacity Building

66. As mentioned, an important cross-cutting theme of the CAS is capacity building. To be able to achieve the CAS and PRSP outcomes and, more fundamental, to be able to monitor and evaluate progress toward achieving these outcomes, there is an urgent need to build capacity in Sri Lanka. Throughout the IDA lending program, there are numerous sectoral operations (e.g., health and education) and technical assistance operations (e.g., economic and public sector reform) which provide support in this regard. In addition, key pieces of the non-lending program—e.g., public expenditure, poverty and reviewing implementation of social policies/programs—will be carried out jointly with local counterparts, both public and private/academic, to strengthen in-country capacity for this essential analytical work. These

¹⁷ See the Thematic Matrices in Annex B11 for a complete elaboration of the results framework.

activities will be fully coordinated with and reinforced by the World Bank Institute (WBI)—for which Sri Lanka is a focus country—which will also play a leading role in the capacity building efforts.

67. WBI will support the CAS peace, growth and equity themes through a variety of face-to-face and distance learning programs (see Appendix VII). With the formal launching of the Sri Lanka Distance Learning Center in February 2003, WBI will be increasingly making use of this facility to reach clients in Sri Lanka. The WBI program will be continuously assessed and adapted to ensure that it is responsive to key institutional capacity weaknesses and bottlenecks in the country. The main priorities for capacity enhancement are in the areas of PRS implementation, governance and the media. In addition, other priorities are in health, nutrition and population, education and rural development.

68. Related to cementing and strengthening the PRS process, WBI will develop programs to: (i) support the establishment of an on-going process of consultation in Sri Lanka; (ii) help Government develop firm linkages and appropriate mechanisms between PRS objectives and budgeting/resource planning, including inter-governmental public finances at both the central and decentralized levels, and (iii) build capacity in designing and implementing a “citizen’s scorecard.” In the area of governance, to assist in the implementation of CFAA recommendations, WBI will engage in programs to strengthen the public accounts and parliamentary committees, focusing on the role of Parliament in the budget and PRS process. Finally, related to the media, programs to enhance the reporting skills of journalists—in English, Sinhalese and Tamil—will be developed and implemented.

69. The PRS learning program is expected to support the achievement of the CAS growth and equity outcomes by strengthening capacity to implement growth-oriented and pro-poor budgets. Strengthening of Parliament under the governance program also contributes to the achievement of the growth and equity outcomes. The development of parliamentary capacity would ensure that: (i) public resource allocation is consistent with constituent demands, as well as with the country’s development objectives; (ii) funds are not misappropriated; (iii) fiscal transparency is maintained; and (iv) PRS expenditures result in improved service delivery. The media program is cross-cutting in nature and is expected to contribute to the achievement of outcomes in all three thematic areas. Generally, it will help to increase transparency of the public decision-making process, which in turn will improve accountability. This process will eventually increase the overall governance and efficiency of development activities. The media will receive training on covering the development needs of a diverse, multi-ethnic society—crucial to the country’s efforts to sustain the peace process. Finally, programs to support other CAS objectives will contribute to achieving the equity outcomes through improving public sector service delivery capability in health (HIV/AIDs communications), education (developing and implementing national education assessments) and rural development (integrated water resources planning).

IDA Non-Lending Program

70. The IDA program is founded on a significantly augmented program of Analytical and Advisory Activities (AAA; see Table 4). Given the strong analytical capabilities existing in Sri Lanka, AAA will all be carried out in conjunction with Sri Lankan agencies, both within Government and the network of research institutions and universities. The AAA program falls into three broad types of activity:

- First, there are major knowledge gaps that need to be filled. These include areas such as poverty mapping and poverty in the North East, the investment climate, sources of growth and progress towards achieving the MDGs.

- Second, there are areas of analysis specifically requested by the Government. These include topics such as urbanization and the role of local government and the reform of the welfare system. It is anticipated that further requests of this type—both through Bank staff and technical assistance (TA)—will be forthcoming and as such, the ability of the Bank to respond to such requests will be retained.

- Third, there is AAA that is necessary as the basis for future lending, especially for sectoral programs. Work in health, education and land are specific examples of this, to help define the priorities for future public expenditure and reform.

71. One of the early programs proposed for support—the e-Lanka program—is itself about the generation and management of knowledge for development. In terms of allocation of the administrative budget, the AAA program will receive an allocation similar to that of the lending program. All core diagnostic economic and sector work will have been completed by the end of FY03, with the exception of the DPR/CEM that will be carried out in FY04¹⁸.

IDA Lending Scenarios

72. The FY03-FY06 *base case* lending program consists of about four projects per year for a total of US\$800 million of IDA resources (see Table 5). While this lending amount is significantly higher than the amount approved during the last CAS period, such an increase is based on a dramatic change both in the peace prospects and the economic policy framework and is merely a restoration of a “normal” lending program for Sri Lanka in line with its IDA allocations.

73. As mentioned, in each year the lending program would be anchored in a PRSC providing program support to the implementation of the PRS. It is envisaged that the four PRSCs might account for close to half of the total four-year lending program. This would be complemented by two to four investment/sectoral operations per year to support key programs in the focus areas. Given the intensity of the conflict, Sri Lanka qualifies for IDA grants for a limited period of time—i.e., FY03 and FY04. In FY03, the IDA grant amount—over and above that approved in December 2002 for the National

Table 4: Key AAA, FY03-FY06

FY03	Area ¹
Social Assessment of the Conflict-Affected Areas	A
Public Expenditure Analysis	A
Country Procurement Assessment Review (CPAR)	A
Country Financial Accountability Assessment (CFAA)	A
Promoting Agricultural & Rural Non-Farm Growth	A
Safeguards Assessment Paper	A
Health Sector Strategy	C
FY04	
Report on Millennium Development Goals (MDGs)	A
Investment Climate Survey (Urban and Rural)	A
Public Expenditure Analysis	A
Development Policy Review (DPR) emphasizing growth	A
AAA on General Education	C
Financing of Municipal Services	B
FY05 ²	
Public Expenditure Analysis	A
Poverty Update	A
Nutrition and Environmental Health	C
Land Policies: Lessons from the LIL	C
FY06	
Public Expenditure Analysis	A
Country Economic Update	A/B
Update on Rural Development Issues	A/B
Review of Implementation of Social Programs	C
¹ Areas correspond to those described in paragraph 70 and are as follows: (A) knowledge gaps; (B) analysis requested by the Government; and (C) necessary as a basis for future lending.	
² At the time of the CAS Progress Report, the AAA timetables will be revisited.	

¹⁸ In summary: (i) the CPAR and CFAA are on-going and will be finalized in FY03; (ii) a Poverty Assessment was finalized in FY01 and will be updated in FY05; (iii) a Public Expenditure Review was completed in FY97 and continuous public expenditure analysis is a key part of the CAS program; and (iv) the last CEM was carried out in FY00 and the DPR/CEM emphasizing growth will be undertaken in FY04.

HIV/AIDs Prevention Project—will be US\$55 million and used to finance the: (i) Second Community Water Project (US\$40 million); and (ii) PRSC (US\$15 million), primarily to support establishment of the monitoring and evaluation mechanisms of the PRS. Assuming that the IDA grant allocation in FY04 is of a similar magnitude, it would most likely be used to finance the: (i) Rural Poverty Reduction Initiative (US\$40 million); and (ii) Health Sector Operation (US\$15 million).

74. An assumption for Sri Lanka to remain in the base case is continued progress in implementing the peace process. In addition, Sri Lanka must meet the triggers shown in Table 6 that cover: (i) maintaining macroeconomic performance, with special emphasis on fiscal issues; (ii) successful implementation of the economic reform program as contained in the PRS; (iii) progress in addressing equity concerns; and (iv) portfolio management. These are broad policy and performance indicators. The “intermediate indicators” in column four of the “Thematic Matrices” in Annex B11 will be used to measure the status of these indicators. Thus, for example, improvements in the quality of education would be measured inter alia by the national learning assessments; factor market deepening by the extent of commercialization of the People’s Bank and labor market legislation and fiscal reform by the size of the public sector domestic borrowing requirement. There are thus a series of specific measures and indicators that will be used to assess performance against these broader categories.

75. The *high case* would have a lending volume approximately 25 percent above the level of the base case. In addition to maintaining performance as envisioned under the base case, the expectation would be for high performance in the following areas:

- Accelerated structural reform, especially in financial sector and public expenditure management;
- Progress in private participation in infrastructure; and
- Deepening of public sector management reforms in the areas of staffing and decentralization beyond that currently envisaged.

76. For the first case, it is proposed that the high case would be reflected in larger PRSCs. In the second, this would trigger specific operations to support those reforms, notably possible investments supporting private participation in water, railway concessioning, landlord port arrangements or IDA guarantees for private power generation investments or toll roads. For the third case, this would trigger additional resources for the public sector management technical assistance programs to cover the costs of re-deployment. Given the triggers, it is unlikely that a high case scenario would be reached for about a year.

FY03		205.0
PRSC I: Factors of Production		110.0
Economic Reform Technical Assistance		15.0
Second Community Water		40.0
National HIV/AIDs Prevention		10.0
Improving Relevance & Quality of Undergraduate Education		30.0
FY04		230.0
PRSC II: Welfare Reform & Rural Development		90.0
e-Lanka		50.0
Rural Poverty Reduction Initiative		40.0
Health Sector Operation		50.0
FY05		195.0
PRSC III: Public Sector Reform		90.0
NE Infrastructure Rehab/Capacity Building		40.0
Public Sector Reform Technical Assistance		15.0
Education Sector Operation		50.0
FY06		170.0
PRSC IV (To be determined)		90.0
Land and Water Administration		40.0
Services for the Urban Poor		40.0

Table 6: Triggers for Different Lending Scenarios

Area	Base Case	High Case ¹
Macroeconomic Management	Progress in macro performance <ul style="list-style-type: none"> PRGF program on track, including reduced net public sector borrowing requirement 	Strong progress in macro performance (as defined in Table 2) <ul style="list-style-type: none"> Strong fiscal management, particularly in terms of resource mobilization and quality of pro-poor public spending via a poverty tracking system in a results-based MTEF
Economic Reforms	Satisfactory implementation of the economic reforms contained in the PRS, specifically: <ul style="list-style-type: none"> Improved functioning of factor markets, notably market orientation of financial sector and greater labor flexibility as measured by transaction times Improved targeting of welfare programs as measured by the share of welfare benefits going to the poor Improved rural economic incentives as measured by number of cleared titles issued to farmers Design and gazette a Voluntary Retirement Scheme (VRS) for the public sector 	Accelerated implementation of the economic reform program, especially with regards to: <ul style="list-style-type: none"> Securing private participation in infrastructure Deepening public sector management reforms as measured by number of departments rationalized/streamlined and reductions in overstaffing Deepening the decentralization process as measured by the share of Government revenues transferred to the local level
Equity	<ul style="list-style-type: none"> Improvements in education quality, especially in poor areas as measured by learning achievements Undertake analysis of the location & sources of poverty, including in the NE 	
Portfolio Management	<ul style="list-style-type: none"> Satisfactory portfolio performance with less than 15% problem projects 	<ul style="list-style-type: none"> Higher portfolio performance with less than 5% problem projects and disbursement ratio over 20%

¹ For the high case scenario, all base case triggers must be met, as well as those in this column.

77. The CAS envisions two types of *low case* scenarios. The first would see lending fall to levels similar to those of the last five years—on the order of US\$250 million over the four year period—with the elimination of the PRSCs, the e-Lanka Project and the technical assistance operations for economic and public sector reform. This low case would be triggered by either: (i) the breakdown of the peace process and the resumption of hostilities, but essentially limited to the North East; or (ii) the lagging behind of structural reforms and a failure to maintain satisfactory macroeconomic performance as evaluated by IMF PRGF program. The deeper low case scenario would be an exit strategy. If the peace process were to break down entirely and hostilities were to break out on a national scale, there would be no new lending and in all probability, it would be necessary to suspend all operations. Nevertheless, it should be emphasized that such a scenario has never been seen in Sri Lanka during the 20 years of conflict and is thus considered highly unlikely.

IFC Program

78. As discussed above, the International Finance Corporation (IFC) will support the growth agenda through investments that contribute to the CAS outcomes related to establishing and fostering private sector participation. IFC will focus on investments which:

- Develop financial markets, increase the availability of financing for SMEs, expand housing finance, add value to the on-going consolidation of financial services, or support the growth of privately-managed contractual savings institutions;
- Expand the private provision of infrastructure services, especially in power, ports, water and telecommunications;

- Support the growth of export-oriented manufacturing and service companies, including IT companies; and
- Support privatization.

In addition, IFC will explore new opportunities to support the growth of SMEs in conjunction with multi-lateral and bi-lateral partners.

MIGA Program

79. During the CAS period, the Multilateral Investment Guarantee Agency (MIGA) will explore the possibility of working with Sri Lanka's investment promotion intermediaries to improve their investor outreach capabilities through the use of the *FDI Xchange*. This e-mail based technology developed by MIGA allows promotion agencies to send customized information to international investors that matches their specified interest in a region, country or sector. With funding provided by the Gateway Foundation, MIGA is prepared to offer hands-on support to appropriate content partners in Sri Lanka who would make use of the *FDI Xchange*. As foreign investor interest in Sri Lanka grows in a post-conflict environment, MIGA would also be ready to help reduce non-commercial risks for foreign direct investors through the provision of guarantees to qualified investments against currency inconvertibility and transfer restrictions, war and civil disturbance, expropriation and breach of contract.

Progress under the Last CAS and Lessons Learned

80. When the previous CAS was presented to the Board, due to the prevailing uncertainties—including the conflict—the low case was considered the most likely scenario. By the time of the Progress Report, Sri Lanka had moved to the mid-base case following the initiation of policy reforms in early-1997. However, the country slipped back into the low case in mid-1999 as the Government became preoccupied with elections, the conflict escalated and reform efforts weakened. As a result, lending to Sri Lanka was relatively modest, with just twelve IDA credits for a total of approximately US\$370 million—or an average of two credits per year for an annual amount of US\$62 million—approved during the period FY97-FY02.

81. As part of the CAS process, a CAS Completion Report for the 1996 CAS has been prepared (see Appendix III). This analysis identifies the major factors—i.e., political instability and the lack of ownership, which often resulted in complex projects that suffered from weak implementation—that contributed to a lack of significant progress towards implementing the CAS program. Similar lessons were highlighted in the Country Assistance Note (CAN) carried out by the Operations Evaluation Department (OED) in December 1998 (see Box 5). These lessons are being taken forward in the design of this CAS in a number of ways, including:

Box 5: Lessons of the Country Assistance Note (CAN)

The main lessons from the December 1998 OED CAN were:

- The physical components of projects—while implemented well—were subject to increasing implementation delays, due primarily to procurement problems;
- Policy changes and institutional reforms were difficult to achieve; therefore, the Bank's assistance should have been more sensitive to the political cycle and substantial preparation and consultation with stakeholders;
- The Bank did not give adequate attention to the possible divisive impact of its programs—e.g., several large education projects could have had greater value if they had fostered the role of education in promoting social inclusion in a more prominent manner; and
- Although the Bank's analysis and advice were sound and its strategic objectives were well-aligned with Government's, only limited institutional framework changes were made.

- Adopting a more realistic approach to the issues of political instability and ownership, specifically by focusing more on: (i) AAA and policy dialogue before jumping prematurely into project preparation; (ii) supporting specific, opportunistic reforms put forward by serious champions with demonstrated implementation ability; and (iii) capacity building;

- Placing greater emphasis on project implementation. In the past, project preparation has often taken more than three years and consumed a substantial share of the administrative budget, thereby leaving limited resources for implementation efforts. In the future, project preparation will be shortened and greater resources will be allocated for implementation;
- Developing simpler, yet larger projects supporting either CDD approaches or comprehensive sectoral/multi-sectoral efforts; and
- Being more selective and focused in areas of engagement, in addition to shifting towards more use of programmatic/adjustment lending instruments.

IDA Portfolio Management

82. After a steady decline during the 1990s, since FY00 the IDA portfolio for Sri Lanka has shown a slight increase in the number of projects, annual lending levels and overall disbursements (see Table 7). Currently, the portfolio consists of thirteen IDA projects and one Global Environmental Facility (GEF) operation with total commitments of about US\$470 million, net of cancellations and an undisbursed IDA balance of about US\$250 million¹⁹.

	FY00	FY01	FY02	FY03
Number of projects under implementation ^{1/}	13	13	13	14
Average implementation period (years) ^{2/}	2.8	3.2	3.8	3.2
New IDA Commitments (US\$ million) ^{3/}	45.2	37.3	75.0	27.6
Disbursements (US\$ million) ^{4/}	45.9	47.4	69.1	44.2
Disbursement ratio (percent)	13.6	15.3	26.3	10.4
Number (percent) actual problem projects ^{5/}	2 (15.4)	2 (15.4)	2 (15.4)	2 (14.3)
Number (percent) projects at risk ^{6/}	2 (15.4)	2(15.4)	2 (15.4)	3 (21.4)
Proactivity index	100	100	100	100
Realism index	100	100	100	100

^{1/}As shown in the Annual Report on Portfolio Performance, including GEF.
^{2/} Average age of projects in the portfolio as of the end of each FY.
^{3/} Commitments approved in FY.
^{4/} Gross disbursements.
^{5/} Projects rated U or HU on Development Objective (DO) or Implementation Progress (IP).
^{6/} Number of actual and potential problem projects.

83. Although the portfolio has experienced some deterioration since the last CAS, since FY02 there have been improvements as a result of the pro-active measures (discussed below) taken by both the Government and IDA²⁰. The most important systemic issues affecting portfolio implementation include: (i) lack of accountability and commitment; (ii) lack of continuity in carrying out reform initiatives; (iii)

¹⁹ Recently approved projects not yet effective—i.e., Economic Reform Technical Assistance and National HIV/AIDS Prevention—are included in these totals. The portfolio restructuring—in which US\$31 million was reallocated to provide support to the North East Emergency Reconstruction Program—is not counted as a stand-alone project.

²⁰ Going into FY02, four projects were identified as “projects-at-risk” and four were on the “watch list” (i.e., potential projects-at-risk). By mid-FY03—through restructurings and/or cancellations—there were only two projects-at-risk and one on the watch list.

poor governance, including weak fiduciary controls; (iv) irregular flow of counterpart funds; and (v) overly ambitious project design.

84. Intensive supervision and management attention to these and other issues have started to produce results. Recognizing that a strong and effective portfolio influences its public image and generates support for reform programs, the Government has taken decisive steps to improve portfolio performance through rigorous monitoring at the highest level and establishing measures to assign direct ownership and accountability to the respective line ministries (see Box 6). In addition, monthly reviews of all donor-funded assistance are conducted by the Ministry of Policy Development and Implementation and chaired by the Prime Minister's portfolio advisor, and monthly meetings are held—chaired by the Department of External Resources with the State Accounts Division and line ministries—to ensure adequate allocation and timely flow of counterpart funds. Specifically related to the IDA portfolio, other on-going activities include: (i) establishment of a Project Directors' Forum—consisting of project directors of all IDA-funded projects—that meets quarterly to address and resolve common issues, share best practices and streamline monitoring and reporting; and (ii) bi-annual portfolio review meetings between IDA, the Ministry of Finance, line ministries and other stakeholders to discuss implementation issues.

Box 6: Improving Accountability in Project Implementation

In September 2002, the Ministry of Finance issued a circular outlining amendments to procedures to deal with issues that “inhibit expeditious project implementation.” Each line ministry Secretary was made fully responsible for coordinating and ensuring timely implementation of projects under his/her purview. As such, financial authority limits have been increased and Secretaries are required to delegate authority to Project Directors to make them more accountable. Furthermore, rigorous procedures for the selection and performance monitoring of Project Directors have been established.

In procurement—in which there have been serious delays in the past—a Cabinet Sub-Committee on Budget and Tenders has been established to oversee all tender decisions and monitor procurement plans. The role of the Procurement Support Bureau as a key advisor in procurement has also been established. Furthermore, revised procurement guidelines—delegating more financial and decision-making authority to Project Directors and Secretaries of line ministries—have been issued.

85. IDA's portfolio management plan focuses on enhancing quality, with special attention paid to social/environmental safeguards and fiduciary controls. For example, quality enhancement reviews are being taken to achieve high quality at entry and emphasis is being placed on establishing procurement plans/systems before project effectiveness. Compliance with social and environmental safeguards will be strengthened through systematic sector reviews, particularly for the energy, infrastructure and irrigation sectors and by building local ownership and capacity to address social and environmental concerns. Greater emphasis will be placed on CDD activities and multi-sectoral approaches, both in rural and urban settings.

86. To ensure more effective portfolio implementation, specific supervision strategies for each sector are being developed. Regional sector specialists will provide quality oversight, while staff in the Colombo Office—supported by the New Delhi procurement hub—will interact with project staff and other stakeholders on day-to-day implementation issues. The underlying principle will be on pre-emptive action to resolve issues before they become full-fledged problems. In addition, more interaction will be undertaken with the media, as this is an essential part of promoting understanding and awareness of the portfolio objectives and for engaging civil society in an open and transparent manner.

IFC Portfolio

87. As of January 31, 2003, IFC had outstanding committed investments in 14 companies in Sri Lanka with a total exposure of US\$74 million, consisting of US\$68 million from its own account (net exposure) and US\$6 million from participating banks. This includes projects in the financial sector, infrastructure, general manufacturing, health care and tourism. In the infrastructure sector, IFC

participated in the South Asia Gateway Terminal project together with ADB, Commonwealth Development Corporation (CDC) and the Private Sector Investment Development Corporation (PSIDC) to develop a quay of the Colombo port as a private container terminal on a 30-year build, operate and transfer (BOT) basis. It also invested in Asia Power—Sri Lanka’s first private power generation project—and Suntel—one of Sri Lanka’s two mobile operators. In the financial sector, IFC activities have included investments in venture capital funds, housing finance companies, commercial banks, the country’s first credit rating agency and support of capital markets through credit lines to leasing companies and other non-bank financial institutions. Portfolio performance is excellent, with no loan arrears.

C. IDA Eligibility and IBRD Creditworthiness

88. While Sri Lanka’s per capita income level is approaching the IDA operational cut-off (US\$875), the country is currently not considered creditworthy for IBRD lending because of political risks and its precarious fiscal position. Previous reviews have concluded that Sri Lanka’s creditworthiness was not strong enough to justify access to IBRD resources because of: (i) the civil conflict; (ii) high total public debt and inadequate fiscal performance; and (iii) vulnerability to external shocks.

89. Nevertheless, given the policy performance envisioned in the base case scenario and the strong prospects for peace, it is possible that Sri Lanka might be deemed eligible for IBRD lending by the time of the next CAS, or even before—i.e., possibly in a high case scenario. With regard to potential IBRD lending in the coming years, the following possibilities exist:

- In a base case scenario, Sri Lanka would remain an IDA-only country during the entire CAS period (i.e., FY03-FY06). A creditworthiness analysis would be carried out in mid-FY06—i.e., to coincide with the preparation of the next CAS—to determine Sri Lanka’s readiness for transitioning to an IDA/IBRD blend-country during the next CAS period; and
- If the triggers for the high case scenario are met and economic performance is in line with the medium-term economic framework set out in Table 2, a review of IBRD creditworthiness could be carried out earlier—i.e., early-FY06²¹. If under this review, Sri Lanka is deemed creditworthy, then the high case scenario could include a limited amount of IBRD lending—primarily for private participation in infrastructure projects. Otherwise, the high case would be an IDA-only scenario.

IV. IMPLEMENTING THE CAS

A. Partnerships

90. There are three types of partnership that are important for this CAS. First, there are official partnerships. Of these, the most important are with JBIC and ADB, the two largest providers of finance to Sri Lanka. The two institutions are currently preparing their assistance strategies and clear efforts have been made to ensure congruence. In February 2003, the Bank and JBIC co-hosted a workshop of the three institutions in Tokyo to discuss their respective strategies and fine-tune coordination. The workshop was extremely successful and permitted the agencies to ensure complementarity between their strategies,

²¹

In moving towards a scenario in which Sri Lanka is considered IBRD creditworthy, first and foremost, there is a need for the country to develop a track record in a number of areas, including solidifying the peace process and macro stability, most importantly in regaining strong growth and fiscal paths. Such a track record could only be established based on the observation of economic and financial performance indicators through 2005, including public debt and fiscal debt levels reached by end-2005. The economic targets as set out in Table 2 thereby provide useful benchmarks against which to assess economic performance and progress.

especially in terms of support to the North East, support to implementation of the PRS, financing of infrastructure and balancing lending. There is a very reassuring degree of complementarity between the strategies—i.e., the Bank is addressing macro constraints on business, while the ADB is focusing on PSD institutions and JBIC is providing support to financial institutions. ADB's focus on sector policy in roads and power has facilitated JBIC financing in these sectors. In education, the Bank is focusing on primary and tertiary education, while ADB interventions are focused on secondary and vocational skills. The Bank is also working closely with the Japanese authorities to ensure the success of the Tokyo Financing Conference for Sri Lanka, scheduled for June 9-10, 2003.

91. The relationship with the UN system is also strong, and ADB, ILO, UNDP, UNHCR, UNICEF and the Bank have been working especially closely together with respect to assessing the needs of the North and East. In addition, coordination with the IMF has been consistently excellent. Currently, the Bank's PRSC is being prepared in parallel with the IMF PRGF and the two institutions are working closely to ensure that the programs are consistent and reinforce each other. As another example of the close coordination, the assessment of the PRS was carried out by a joint Bank/IMF team.

92. An important part of the coordination efforts revolves around selectivity in implementing the PRS—i.e., development partners are working together to ensure that duplication is minimized, while at the same time, all essential components of the PRS are receiving adequate support. The multi-lateral and bi-lateral partnerships for implementing the PRS are summarized in Table 8.

PRS Area	Bank Theme	Multilaterals	Bilaterals
Monetary and fiscal policy	Growth	ADB, IMF	
Maintain price stability	Growth	IMF	
Trade and investment policy reform	Growth	ADB	US
Labor market reform	Growth	ADB, IMF, UN agencies	
Financial sector reform	Growth	ADB, IMF	Sweden
Public enterprise reform	Growth	ADB, IMF	Japan
Power sector reform	Growth	ADB	Germany, Japan
Reduce conflict-related poverty	Peace	ADB, EU, UN agencies	France, Germany, India, Netherlands, Norway, UK
Create opportunities for pro-poor growth	Growth	ADB, EU, UN agencies	India, Japan, Netherlands, Norway, Sweden
Foster SME development	Growth	ADB, EU	Germany, Japan, Sweden
Assist ultra-poor communities	Equity	ADB	Germany
Mainstream poverty reduction objectives in sector strategies	Peace, Growth, Equity	ADB, UN agencies	Germany, Japan, Norway, Sweden, US
Equip all students with knowledge/skills to suit the modern employment market	Equity	ADB, UN agencies	Austria, China, France, Germany, Japan, Korea, Norway, UK
Provide safe water/sewage/sanitation systems to all	Equity	ADB, UN agencies	France, Germany, Japan, Norway
Restructure the social protection system	Growth	ADB, UN agencies	Australia, Germany, Japan, Netherlands, Norway, Sweden
Reform governance and empower the poor	Growth, Equity	ADB, UN agencies	Australia, France, Japan, Netherlands, Norway, Sweden
Gender development	Throughout	UN agencies	Canada
Expand opportunities for micro-enterprise development	Growth	ADB	Canada, Japan

93. This being said, nevertheless, Government leadership of the coordination of development partners leaves much to be desired. This is an area that the Bank is working with ADB in trying to improve, especially to ensure continuity between meetings of the Development Forum.

94. The second type of partnership is with the private sector—especially, the Chambers of Commerce. These are exceptionally well-organized in Sri Lanka and routinely prepare inputs to policy formulation, such as comments on the draft PRS and suggestions for the budget. The Ceylon Chamber of Commerce—one the oldest in the world—is collaborating with the Bank to prepare the Development Gateway for Sri Lanka and will be an important partner in carrying out the investment climate work and other initiatives affecting the private sector.

95. Partnership with civil society is mixed. On the development implementation front, it is going well in such projects as the NEIAP, in which Non-Governmental Organizations (NGOs) are performing strongly in their role as social mobilizers. NGOs are also playing a significant part in the North East Emergency Reconstruction Program. However, there is not a very well-organized framework for policy consultation, and no structured framework exists for exchange of views between the Government, the Bank and civil society. Thus, there are those who felt fully consulted on the PRS and others who never saw it. This will receive increased attention during this CAS period, especially through the efforts of WBI. Priority will also be placed on building better partnerships with the media and improving the Bank's external communications efforts with regard to both lending and non-lending activities.

B. Monitoring of Outcomes

96. As mentioned above (see paragraph 65), effective monitoring and evaluation is critical for tracking implementation of the PRS, and hence, the CAS outcomes. The Thematic Matrices—contained in Annex B11—identify clear, specific indicators that will be used to measure progress toward achieving the CAS outcomes. In the coming months, as emphasis is placed on monitoring and evaluation systems, for each of the indicators, annual targets for the CAS period will be established and agreed with the Government. Preliminary indications are that sufficient information is available to carry out this exercise as envisioned. However, there is still the need to determine whether or not valid and verifiable data exist—including baseline information—to measure real progress towards achieving all of the CAS outcomes.

C. Risks

97. There are five types of risk associated with this CAS. In Box 7 these risks are listed in order of importance, with the first two—peace and politics—being the most critical. This is therefore a relatively risky strategy. It is intentionally so, because of the historic moment at which Sri Lanka finds itself. The Government and indeed the LTTE are themselves being very bold and taking enormous risks with respect to their own political futures, for the sake of a better future for the people of Sri Lanka. It seems only reasonable that the Bank should also be prepared to accept the risks of this strategy so long as the two parties remain committed to achieving peace and laying the foundation for a renewed attack on poverty. It is therefore a strategy that has high risks, but potentially very high rewards in a country that for too long has been performing below its full potential. Sri Lanka now has the opportunity finally to break out of the conflict and follow a path of sustained progress for all its people. The World Bank Group can make a substantial contribution to this process.

98. To handle these risks, several mitigation strategies are being adopted. First, with Bank support, a major communications program is being developed to present and explain the reform program to the population. This should reduce resistance to the reforms. In addition, a major program of technical assistance for the reform process has been approved—i.e., the Economic Reform Technical Assistance Project—which should boost implementation capacity. Both the IMF and the Bank will also provide support to strengthen the monitoring and evaluation capacity building effort.

99. The political risks are harder to mitigate, but should be tractable so long as the Government retains the confidence of Parliament. The successful implementation of the reform program and successful negotiation of the peace process are the best guarantees of this. With regard to the peace process, there is every indication of strong commitment from both sides and the best prospect to supporting this is an early demonstration of the benefits of peace. Thus, the Bank—along with other development partners—will provide early support for reconstruction efforts as part of the strategy. Finally, the external shocks require that foreign reserves be built up as quickly as possible. This would require appealing for this type of for external assistance during the forthcoming Financing Conference for Sri Lanka planned for June in Tokyo.

100. Sri Lanka now has the opportunity to break out of the conflict and follow a path of sustained development and progress for all its people. This CAS presents a coherent strategy for how the World Bank Group should support Sri Lanka to help this opportunity be realized.

Box 7: CAS Risks

Peace: the biggest uncertainty is whether peace will indeed be achieved this time. It has been noted that the process is going remarkably well and that both sides appear determined. But after 20 years and several failed attempts, claiming certainty would be foolish. The Bank is ensuring resources are available for reconstruction and has a strategy in the event hostilities were to resume.

Politics: Sri Lanka is going through “cohabitation”—i.e., a President from one party and a Government from another—for the first time. The President has the constitutional power to dismiss the Government and call elections. Such an event would obviously disrupt both the peace process and economic reform. The President has stated that she will not call elections as long the Government continues to command the confidence of Parliament. But, a political crisis remains a risk for this strategy.

Economic reform: the Government is committed to reform, but could face serious opposition to some of its policies, such as in the financial sector. In addition, if economic reform were to threaten the peace process Government might slow down. Thus, the level of support is linked to both the pace and quality of reform.

External: Sri Lanka remains a country with heavy external dependence. If the situation in the Middle East were to deteriorate, international tourism and remittances might decline significantly just as the Sri Lankan economy is recovering.

Implementation: the CAS proposes a major increase in lending at a time when Sri Lanka’s own resources are heavily stretched, raising the question of absorptive capacity. Significant resources will be transferred in the form of program assistance. This is easily absorbed and in and of itself makes it easier for project assistance to be absorbed.

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