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Country Partnership Strategy for Sri Lanka

Towards Middle Income Country Status

2012 - 2016



THE WORLD BANK



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Currency & Equivalentents
 Currency Unit = Sri Lanka Rupees (Rs)
 US\$ 1= Rs.128 (as of April 16, 2012)

Fiscal Year
 January 1 – December 31

Abbreviations & Acronyms			
AAA	Analytic and Advisory Activities	MSME	Micro Small Medium Enterprises
ADB	Asian Development Bank	MPs	Members of Parliament
AUSAID	Australian Government Overseas Aid Program	NDP	National Development Planning
BB	Bank Budget	NIPP	Netherlands IFC Partnership Program
BOP	Balance of Payments	NLTA	Non-Lending Technical Assistance
CAS	Country Assistance Strategy	OECD	Organization for Economic Cooperation and Development
CASCR	Country Assistance Strategy Completion Report	ORAF	Operations Risk Assessment Framework
CBSL	Central Bank of Sri Lanka	PADGO	Portfolio Approach to Distributed Generation Opportunity
CDD	Community Driven Development	PEFA	Public Expenditure and Financial Accountability
CPIA	Country Policy and Institutional Assessment	PER	Public Expenditure Review
CPS	Country Partnership Strategy	PFM	Public Financial Management
DCS	Department of Census and Statistics	PIU	Project Implementation Unit
DPL	Development Policy Lending	PPPs	Public Private Partnerships
ESCAP	Economic and Social Commission for the Asia Pacific	ESW	Economic and Sector Work
MoFP	Ministry of Finance & Planning	EU	European Union
FDI	Foreign Direct Investment	ROSC	Report on Standards and Codes
FY	Financial Year	RE	Recipient Executed

Abbreviations & Acronyms

GAAP	Generally Accepted Accounting Principles	SMEs	Small and Medium-sized Enterprises
GDP	Gross Domestic Product	SOEs	State Owned Enterprises
GPOBA	Global Partnership on Output Based Aid	SWAP	Sector Wide Approach
IBRD	International Bank for Reconstruction and Development	SPN	Supervision
ICT	Information Communication Technology	TA	Technical Assistance
IDA	International Development Authority	TF	Trust Fund
IDF	Institutional Development Fund	UN	United Nations
IDPs	Internally Displaced Persons	UNDP	United Nations Development Program
IFC	International Finance Corporation	UNHCR	The United Nations Refugee Agency
IFRS	International Financial Reporting Standards	USAID	United States Agency for International Development
IMF	International Monetary Fund	USD	United States Dollars
LEN	Lending	VAT	Value Added Tax
LLRC	Lessons Learnt and Reconciliation Commission	WB	World Bank
M&E	Monitoring and Evaluation	WBG	World Bank Group
MDG	Millennium Development Goal	WDI	World Development Indicators
MIC	Middle Income Country	YOY	Year on Year
RDA	Road Development Authority		



Country
Partnership
Strategy for
Sri Lanka

executive
summary





Thirty years later,
Sri Lanka is ready
to rise again...



executive summary

i. **The Sri Lankan country context has evolved considerably since the FY09-12 Country Assistance Strategy (CAS) was prepared.** The 26-year conflict ended in May 2009 and resettlement of Internally Displaced Persons and demining are now largely complete. Sri Lanka is transitioning to middle income country status. The macroeconomic situation has improved. Sri Lanka can now focus on long-term strategic and structural development challenges.

Key challenges include realigning public spending and policy with the needs of a middle income country, ensuring opportunities for all Sri Lankans to benefit from economic growth, ensuring appropriate resource allocations for the various tiers of Government, addressing the opportunities and impacts of the demographic transition, and enhancing the role of the private sector including provision of appropriate incentives for increasing productivity and exports.

ii. **The Country Partnership Strategy (CPS) for FY13-16 is designed to assist the Government of Sri Lanka to address the long term strategic and structural development challenges, while using the existing portfolio to support ongoing efforts to restore livelihoods of Internally Displaced Persons and others affected by the conflict.** The World Bank Group's relationship with the Government has strengthened with increased dialogue and support on the middle income country agenda. In recognition of its growth and economic stability, Sri Lanka has access to IBRD financing as of FY12, allowing for significantly increased financial support during the coming years.

iii. **Recognizing the need for sustained effort following the end of the conflict, the 2011 World Development Report on Conflict, Security and Development provides valuable insights for this CPS.** Many of the principles of engagement proposed by the World Development Report are relevant for Sri Lanka: delivering early results to build public trust and confidence, strengthening institutions in a phased approach, focusing on social accountability, enhancing political and economic inclusion and applying community managed/driven approaches. Many of these principles, including community managed/driven approaches, were central in the FY09-12 CAS. This CPS continues to encompass these principles.



Rebuilding a nation from hamlet to high-rise

iv. **This CPS provides support to address the challenges for achieving the Government’s vision as laid out in the “Mahinda Chintana, Vision for the Future”.** For each of the three central goals of the Government’s vision, the CPS lays out the key areas of engagement in which World Bank Group support can most effectively address the identified challenges. These areas of engagement were developed through a process of eighteen thematic consultations with the Sri Lankan Government, private sector, civil society, development partners and other stakeholders. Addressing these challenges will require a set of structural and behavioral changes in line with the new middle income status of Sri Lanka.

v. **The first goal of the Mahinda Chintana -- to increase per capita income to US\$ 4,000 by 2016 - will require sustained high economic growth (8 percent per year), driven by a high investment rate.** Of the targeted investment rate (33-35 percent of GDP per year), 6-7 percent of GDP per year is expected to come from public investment with the remainder coming from the private sector. While public sector investment targets were achieved in 2010 and 2011, it will be difficult to sustain these levels in the absence of increased fiscal space. On the private sector investment side, the level reached 22 percent and 23 percent in 2010 and 2011 falling short of the targets. Reversing this trend will require concerted efforts to improve the investment climate.

vi. **The second goal is shifting towards a more knowledge-based, globally integrated and competitive, environmentally friendly, internally integrated and increasingly urban economy.** Sri Lanka has a solid base for achieving this goal, with a well educated population and a wealth of environmental assets. Challenges going forward include providing systems and incentives to build an appropriately skilled labor force, establishing economic policies that encourage competitiveness, stronger efforts on environmental sustainability and adaptation to climate change, and modernizing infrastructure systems to integrate the disparate parts of the country and meet the needs of the increasingly urban population.

vii. **The third goal is ensuring improvement in living standards and social inclusion.** With its long history of attention to access to basic services, Sri Lanka excels for its income level on most social indicators, with the exception of malnutrition. As Sri Lanka becomes a middle income country, new challenges are emerging (e.g. a rapidly aging population) and improving the quality of services will be a major issue. While increasing the quality of services, an important challenge will be to ensure that benefits are equitably shared across all segments of the population and to prioritize social inclusion and ethnic reconciliation.

executive summary Contd...

Successful achievement of this goal will require continuation of Government efforts to resettle Internally Displaced Persons, to invest in the conflict-affected areas of the North and East, and to engage with the political opposition.

viii. **The proposed FY13-16 CPS builds on the successful engagement under the FY09-12 CAS and deepens the World Bank Group's support to Sri Lanka in addressing its emerging middle-income country agenda.** It is designed to be flexible, focusing on a small number of large projects. Further, country systems will be used to the extent possible. Moving toward increased harmonization with country systems and coordination with other development partners will be especially important in sector wide approaches.

This engagement will be supported by International Development Association (IDA) and International Bank for Reconstruction and Development (IBRD) resources, using a full range of lending and non-lending instruments. The International Finance Corporation (IFC) will continue to play a key role in providing investment and advisory services to the private sector.

ix. **The CPS focuses on three areas:** These are:
(a) facilitating sustained private and public investment
(b) supporting the structural shifts in the economy
(c) improving living standards and social inclusion

x. **In the area of sustained private and public investment, the World Bank Group will support the Government effort to improve the investment climate, strengthen governance and reduce the inefficiencies of the public sector.** The IFC plans to catalyze private investment through directly investing in important projects in key sectors. The World Bank will also support the Government's efforts to maintain a high level of public investment and improved efficiency of public expenditures and financial management and procurement practices in line with international standards, using both knowledge (e.g. Public Expenditure Review and Public Expenditure and Financial Accountability Assessment) and lending products (e.g. a development policy loan for investment policy and governance reforms and an investment loan for legal and judicial reforms). The World Bank will also advise Government on ways to improve the efficiency of key State Owned Enterprises (SOEs).



- 1) Nurturing better maternal and childcare for a healthier tomorrow
- 2) Building roads that lead to rebuilding livelihoods
- 3) Fostering a participatory school education system
- 4) Reigniting the nation with a skilled labour force



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xi. **In supporting a structural shift in the economy, the World Bank Group will deepen its assistance to the knowledge based economy with investments in skills, research and innovation.** In addition, support to the development of infrastructure needed for sustainable urban development and better linkages within Sri Lanka will be enhanced.

xii. **Finally, the World Bank Group will continue to support improvements in living standards and social inclusion in order to ensure the benefits of rapid growth and higher quality services are broadly shared.** Activities in this area already include three ongoing livelihood projects in the conflict-affected North and East regions of the country which includes restoration of basic infrastructures, housing construction, and cash for work as well as support for starting new businesses.

During the CPS period, the program will further include:

- (a) support to the national health sector program with a focus on supporting emerging service delivery demands resulting from Sri Lanka's aging population, such as work on non-communicable diseases
- (b) inter-sectoral efforts to address malnutrition, economic integration of women and a range of other activities to further support the needs of women, youth and the disabled

- (c) analytical work on allocation of resources and benefits received by various groups
- (d) IFC's support for inclusive growth

xiii. **The CPS includes an indicative pipeline of projects for financing. Reviews will be held annually to monitor CPS implementation and ensure continued alignment of the CPS with the evolving country needs.** The program will be supported by approximately US\$ 577 million (SDR 374.2 million) in funding under the remainder of IDA 16. The program will also be supported by a total of approximately US\$ 450 million in IBRD financing over the period FY13-FY14.

The Government has expressed interest in a significantly larger amount of IBRD financing for the outer years of the CPS, which would depend on the macroeconomic environment in Sri Lanka as well as the overall demand for IBRD resources from other clients, IBRD financial capacity and global economic developments. A Progress Report will be prepared in FY14 at which time any necessary revisions to the program, including the lending plans, will be discussed.



Revisiting the learning process from preschoolers to post-graduates

xiv. **Increased attention will be paid to results in all sectors.** The choice of lending instrument will depend on the specific needs. Alongside specific investment loans, instruments are expected to include Development Policy Loans and Program-For-Results financing, as client demand and other conditions permit. Analytical work will also focus on results by helping to identify the driving forces and key constraints that need to be addressed through policies and investments.

xv. **This CPS includes a careful assessment of key risks in the program, and steps to manage such risks.** The first set of risks is related to the implementation environment and is reflective of Sri Lanka's specific development challenges. These include:

- (a) external shocks emanating from Euro Area crisis
- (b) macroeconomic and fiscal risks
- (c) natural disasters

The second set of risks is related to the design of the program itself. These include portfolio risks related to governance, procurement and financial management and risks related to government capacity to manage the increased volume of lending.

The CPS presents ways to mitigate these challenges. Moreover, the flexible approach of this CPS will allow adjustment in the program in line with evolving Government priorities and country needs, within the broad direction for engagement outlined in this CPS.

This CPS provides support to address the challenges for achieving the Government's vision



Country
Partnership
Strategy for
Sri Lanka

country
context

1. **The Sri Lankan country context has evolved considerably since the FY09-12 Country Assistance Strategy (CAS) was prepared.** The 26-year conflict ended in May 2009 and resettlement of Internally Displaced Persons and demining are now largely complete. The attainment of peace bolstered economic performance. The Sri Lankan economy grew at 8 percent average per year since the end of the conflict. Inflation is relatively low at about 6 percent in 2011, down from 22.6 percent in 2008. Public debt and deficit have been gradually brought down and Sri Lanka is transitioning to middle income country status.¹

2. **Sri Lanka can now focus on long-term strategic and structural development challenges.** Key challenges include realigning public spending and policy with the needs of a middle income country, ensuring opportunities for all Sri Lankans to benefit from economic growth, ensuring appropriate resource allocations for the various tiers of Government, addressing the opportunities and impacts of the demographic transition, and enhancing the role of the private sector including provision of appropriate incentives for increasing productivity and export.

3. **The Country Partnership Strategy (CPS) for FY13-16 is designed to assist the Government of Sri Lanka to address these long term strategic and structural challenges, while using the existing portfolio to support efforts to restore livelihoods in the parts of the country most affected by the conflict.** The World Bank Group's relationship with the Government has strengthened with increased dialogue and support on the middle income country agenda. In recognition of its growth and economic stability, Sri Lanka has access to IBRD financing as of FY12, allowing for significantly increased financial support during the coming years.

4. **Recognizing the need for sustained efforts following the end of the conflict, the 2011 World Development Report on Conflict, Security and Development provides valuable insights for this CPS.** Many of the principles of engagement proposed by the World Development Report are relevant for Sri Lanka: delivering early results to public trust and confidence, strengthening institutions in a phased approach, focusing on social accountability, enhancing political and economic inclusion and working with structures at the local level to identify priorities and deliver programs.

1 GNI per capita was US\$ 2,290 in 2010 and about US\$ 2,350 in 2011.



- 1) Keeping the public sector plugged into a new way of working
- 2) Taking local infrastructure to newer heights
- 3) Nourishing micro financed ventures for better harvests
- 4) Unveiling new opportunities for rural entrepreneurs



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Many of these principles were central in the FY09-12 CAS. This CPS continues to encompass these principles and adopts a pragmatic approach to address immediate and medium-term challenges towards strengthening basic institutional functions towards providing shared growth, security, justice and jobs. As such, it is strengthening institutions including the Auditor General and judiciary, enhancing the transparency and communication between Parliament and civil society, utilizing third party monitoring of projects, and emphasizing equitable allocation of resources and public service provision across the country to ensure that all Sri Lankans benefit.

A. POLITICAL AND SOCIAL CONTEXT

5. **The current Government has strong political support.** President Rajapaksa was first elected in 2005. Following a concerted military campaign, the Government defeated the separatist Liberation Tigers of Tamil Eelam in May 2009. President Rajapaksa was re-elected in 2010 with a strong majority. Subsequent parliamentary, provincial and local elections have also brought strong support for the President's United People's Freedom Alliance. At the national level, the opposition now holds less than one third of Parliamentary seats.

6. **Resettlement of internally displaced persons and demining have been major focuses of the past two years.** About 277,000 people were displaced within the country during the conflict. The vast majority have been resettled, though about 14,000 individuals still remain in welfare centers and camps.² Many have returned to areas that were destroyed during the conflict and major efforts are ongoing to re-establish public services and infrastructure as well as to rebuild housing and re-establish income generating activities. Many development partners, including the World Bank, have supported the Government in the resettlement effort.

7. **Broad social and economic inclusion has been occurring slowly and further progress is still required.** A long lasting solution to the ethnic problem and setting up effective means of addressing grievances of minority communities is vital for sustained peace. President Rajapaksa appointed the Lessons Learnt and Reconciliation Commission and mechanisms have been put in place to implement key recommendations of the Commission. This process is closely monitored by the Government with support of key bilateral partners.

² Data from UNHCR estimates.



Weaving new hope for new settlements



Monitoring progress of infrastructure by villagers assuring better accountability

8. **Sri Lanka is on track to meet most of the Millennium Development Goals.** UNDP has identified Sri Lanka as an early achiever on 10 of the 21 indicators, including those related to universal primary education and gender equality. Sri Lanka is also expected to meet the goals of maternal health and HIV/AIDs.

However, Sri Lanka is making slower progress on the goals related to malnutrition and child mortality. Indicators are mixed on the environment: while Sri Lanka is an early achiever on indicators of protected area, ozone depleting substance consumption, safe drinking water and basic sanitation, it has stagnated or is slipping backwards on forest cover and CO₂ emissions.³

3 Paths to 2015: MDG Priorities in Asia and the Pacific (2010/2011) by UNDP, Economic and Social Commission for Asia and the Pacific (ESCAP) and ADB.

9. **Sri Lanka compares favorably with other countries in its income band in terms of gender equality.** Sri Lanka ranks 72nd out of 169 countries on the UN Gender Inequality Index.⁴ On the OECD's Social Institutions and Gender Index, Sri Lanka scores highest among all South Asian countries.⁵ The main gender challenges relate to women's access to employment opportunities and women's nutritional status. Only 32.3 percent of females aged 15 or older participate in the labor force.⁶

Poor nutritional status of women is particularly severe in estate areas: the percentage of women with low body mass index is nearly 48 percent in estate areas, compared to 23 percent of rural areas, and just 12 percent in urban areas. Poor nutritional status of women reduces the woman's own quality of life as well as her earning capacity and the health of her children.

4 The Gender Inequality Index is a composite measure of reproductive health (maternal mortality ratio and adolescent fertility rate); women's empowerment (share of parliamentary seats held by women; and female secondary and tertiary educational attainment rates); and labor participation (share of women in the labor force). United Nations 2008.

5 The OECD index looks at family law, civil liberties, physical integrity (including violence against women), son preference and ownership rights.

6 Female labor force participation is highest (50.2 percent) among those aged 40-44 years as of second quarter 2011. Female labor force participation rates would be somewhat higher if the large number of Sri Lankan women working outside the country (primarily as housekeepers) were included.



Guiding new mothers with helpful childcare advice



Using community radio as a means of sharing information on nutrition

10. **Sri Lanka's changing demographics – the aging and urbanization of the population – is having dramatic impacts on education and health as well as the economy.** By 2036, more than 22 percent of the population will be over 60 and there will be 61 dependents per 100 adults. Unless labor force and employment rates increase, a very small number of employed persons will need to provide for a very large number of non-working persons – straining the budgets of families and Government.

As the population becomes older and has a higher income, the types of public services required will change. The education system will need to give increasing emphasis on computer, English and higher level cognitive skills. The health system will need to focus more on non-communicable diseases.⁷ Social protection for the elderly will need to be enhanced. Increasing urbanization will require investments in mass transit and expanded water and sewage networks.

7 Non-communicable diseases are those diseases that are not transmissible from one person to another, including a wide array of health conditions such as injuries, mental health problems, disabilities, cardio-vascular diseases, endocrine disorders such as diabetes mellitus, non-infectious respiratory diseases such as asthma, degenerative diseases of old age, and cancers.

11. **Unemployment rates have fallen since the end of the conflict.** As of second quarter of 2011, unemployment was only 4.2 percent. Unemployment rates are higher among youth, women and the more educated: the unemployment rate was 7.6 percent among those 25-29 years old, 7.0 percent among women, and 7.8 percent among those with A-Level education and above.⁸ More than half (about 55 percent) of the employed population works as a paid employee⁹, although even among this group, a large share is in the informal sector.¹⁰

8 The Advanced Level General Certificate of Education, commonly referred to as an A-level, is a qualification offered by education institutions in Sri Lanka and other Commonwealth Countries. A-levels are studied over a two-year period and are recognized as the standard for assessing the suitability of applicants for academic courses in universities.

9 The remainder work as entrepreneurs or unpaid family workers.

10 The figures in this paragraph are from the Department of Census and Statistics Bulletin of Labor Force Statistics for 2011Q2.

12. **Poverty rates have fallen from 15 percent of the population in 2006/7 to 9 percent in 2009/10.**¹¹ The most dramatic decline has been in the estate sector (from 32 percent to 11 percent) following a major wage increase at the beginning of 2010. Remaining concentrations of poverty are not limited to a single part of the country: the four districts with the highest poverty rates are Batticaloa (20 percent) in the east, Jaffna (16 percent) in the north, Moneragala 15 percent in the south-east and Badulla (13 percent) in the south-east.¹² Inequality of consumption declined between 2006/7 and 2009/10, with the Gini index falling from 0.40 to 0.36 and the quintile ratio falling from 6.7 to 5.7.

11 These numbers are based on the national poverty line. Poverty rates are calculated separately for urban, rural and estate (plantation) sectors. World Bank estimates using international poverty lines find that as of 2007, 7 percent of Sri Lankans were below the US\$ 1.25 line and 29 percent of Sri Lankans were below the US\$ 2.00 line.

12 The 2009/10 survey did not include the Mannar, Kilinochchi and Mullaithivu Districts. The poverty rate in Colombo is under 4 percent.

B. ECONOMIC CONTEXT AND RECENT ECONOMIC DEVELOPMENTS

13. **The Sri Lankan economy grew at a vigorous 8.3 percent during 2011, largely due to the post-conflict rebound.** Sri Lanka was able to maintain relatively strong growth of about 5 percent per year even during the war, though growth dropped to 3.5 percent in 2009 during the last stage of the conflict, which coincided with the international economic crisis.

The post-conflict rebound has helped all sectors, both on the supply side and the demand side. Agricultural land in conflict-affected areas could once again be cultivated; double shifts in manufacturing became possible as workers no longer had to worry about security restrictions. Domestic consumers' and investors' confidence revived, and services related to tourism picked up as tourist arrivals surged since the end of the war.

country context Contd...

14. **Sri Lanka has been experiencing an increase in the trade deficit, estimated to be about 17 percent of GDP in 2011.** Goods exports declined as a share of GDP from 30 percent in 2001 to 18 percent by 2011. Sri Lanka's low share of GDP from exports is not an outlier in the world perspective, but as an economy with a relatively small domestic population, with a favorable geographic location as a trade hub and close proximity to fast growing markets, Sri Lanka's exports are below potential. Although exports have increased, they have not kept pace with the surge in imports. Increased imports reflected a rapid rise in consumer imports, tied to the rising income of the population; increased investment goods imports to support infrastructure development; and an increasing bill for intermediate goods imports due to higher commodity prices, notably oil.

15. **The trade deficit has been financed largely by remittances (about 9 percent of GDP in 2011) and to a lesser extent by tourism receipts (1.5 percent of GDP in 2011).** In 2010 the trade deficit was comfortably financed by remittances and tourism. However, despite strong remittances and tourism, the large increase in the trade deficit resulted in a more than doubling of the current account deficit and a rapid decline in foreign reserves in 2011.

In February of 2012, the authorities introduced a package of measures to rein in the current account deficit, stem the reserve loss, bolster fiscal performance and increase the sustainability of growth. These measures included monetary and credit policy tightening, petroleum and electricity price increases, a petroleum tax increase and the abolishment of the rupee trading band to allow the exchange rate to adjust more flexibly. At the same time, the authorities increased the kerosene coupons available to the poorest in order to mitigate the adverse impact on that group.

16. **The public debt and deficit have been gradually brought down.** Public debt is estimated at 79 percent of GDP as of December 2011, compared to nearly 91 percent of GDP in 2005.¹³ The fiscal deficit excluding grants reached 10.4 percent of GDP in 2009, but the authorities made significant stabilization efforts under the IMF program since then to gradually reduce it to an estimated 6.9 percent of GDP in 2011.¹⁴

¹³ Domestic public debt is currently about 44 percent of GDP.

¹⁴ Reduced fiscal deficit was accomplished in large part through higher receipts from import duties, VAT and excise taxes.

The debt sustainability analysis performed by the IMF in 2010 found the public debt to be sustainable and projects it to decline to 64 percent of GDP by 2015, assuming 6.5 to 7 percent annual growth, 6 to 7 percent nominal interest rates and continuous fiscal stabilization efforts.

17. **Inflation remains low.** Having reached 22.6 percent (annual average) in 2008, inflation has fallen to about 6.0 percent in 2011. Monetary policy has been accommodative since the start of the global economic crisis.¹⁵ Strong credit expansion since 2009 has helped stimulate domestic demand. After falling by 5.8 percent in 2009, credit to the private sector increased by 24.9 percent in 2010 and about 33 percent in 2011 year-on-year. In its recent report, the Fitch ratings agency has warned that such fast credit growth, if maintained, and fast rising asset prices may be putting the financial system at risk.¹⁶

To address such concerns, the Central Bank of Sri Lanka recently raised policy interest rates.¹⁷ This move is expected to reduce growth in private sector credit and domestic demand and reduce emerging risks to the financial sector.

Sri Lanka's changing demographics is having dramatic impacts on education and health as well as the economy

15 Policy rates were lowered by a cumulative 350 basis points from November 2008 to January 2011 simulating credit demand.

16 Fitch Asia-Pacific Sovereign Outlook, December 23, 2011.

17 The Central Bank of Sri Lanka raised policy interest rates by 50 basis points in February 2012.

country context Contd...

Key Macroeconomic Indicators

As a percent of GDP	2008	2009	2010	2011 Est	2012 F	2013 F	2014 F	2015 F	2016 F
National Accounts									
Real GDP growth	6.0	3.5	8.0	8.3	6.8	7.7	7.0	7.0	7.0
Total investment	25.3	23.7	27.8	29.3	32.9	29.5	29.3	29.1	31.3
Private sector investment	19.3	17.3	22.0	23.3	26.9	23.7	23.6	23.4	25.3
Public sector investment	6.0	6.4	5.8	6.0	6.0	5.8	5.8	5.7	6.0
Monetary									
CPI	22.6	3.4	5.9	6.0	6.0	6.0	6.0	6.0	6.0
Public debt	81.4	86.1	81.9	78.8	75.4	71.1	67.6	64.2	60.7
External Account									
Current account balance	(9.5)	(0.5)	(2.9)	(7.0)	(3.2)	(2.7)	(2.8)	(3.0)	(2.1)
Trade balance	(14.7)		(10.5)		(14.9)		(16.3)	(17.6)	(18.6)
FDI	1.7	0.9	0.9	1.7	2.4	2.1	1.2	1.1	1.3
Remittances	7.2	7.9	8.3	9.1	9.7	10.3	11.1	12.0	13.4
Gross International Reserves of CBSL in months of imports	1.4	5.7	5.7	3.4					
Fiscal									
Fiscal revenues	15.6	15.0	14.9	15.7	16.0	16.2	16.3	16.3	16.5
Primary current expenditure	16.9	18.2	16.7	16.3	16.0	15.4	15.0	14.7	14.8
Interest expenditure	4.8	6.4	6.3	5.4	5.2	5.0	4.8	4.6	4.7
Capital expenditure	5.7	6.7	6.4	6.0	6.2	6.0	6.0	6.0	6.0
Fiscal balance excluding grants	(7.7)	(10.4)	(8.2)	(6.9)	(6.4)	(5.5)	(5.0)	(4.6)	(4.3)

IMF and World Bank Group staff estimates

18. **Sri Lanka entered into a US\$ 2.6 billion IMF Stand-By-Arrangement in July 2009. The program aims to put Sri Lanka on a sustainable growth path, rebuild foreign exchange reserves, strengthen the fiscal position, bring down inflation and strengthen the financial system.** In April, 2012, the Executive Board of the IMF completed the seventh review of Sri Lanka's economic performance and disbursed SDR 275.6 million (about US\$ 426.8 million) bringing total disbursements under the arrangement to about US\$ 2.13 billion. In addition, the Executive Board approved an extension of the arrangement period to July 23, 2012, to allow time for the completion of the eighth and final review.

C. ECONOMIC OUTLOOK

19. **The Government's strategy aims at eight percent annual real growth over the medium term.** Whereas the recent growth has been achieved in large part due to the one-time benefits of the end of the conflict, sustaining strong growth will require continued efforts to increase investment and raise productivity. To date, both domestic private investment and FDI have been well below desired levels: domestic private investment was 20.1 percent of GDP and FDI was 0.9 percent of GDP in 2010.¹⁸ Improvements in the investment climate will be essential to achieving sustained growth, and investor confidence is expected to continue to depend heavily on predictability of the policy environment.

18 The official numbers for 2011 are not yet publicly available.

country context Contd...

In addition to high investment ratios, total factor productivity increases will be crucial, particularly as the share of the population of working age declines. Increases in productivity will depend in large part on opening up the economy, a higher exposure to global knowledge and innovation, and general progress in the efficiency of production processes.¹⁹

20. **Over the CPS period, both exports and imports of goods are expected to grow rapidly.** As imports will start from a higher base, the merchandise trade deficit is expected to widen and remittances will continue to be a major source of financing. Imports are expected to increase in investment goods and intermediate goods as the economy rebuilds following the conflict, as well as in consumer goods, as an increasingly wealthy population demands a wider range of imported products.

There are several potential areas for increased exports, including expanding labor intensive production (e.g. garments) as China moves out of these markets. The risks of declining export demand if the economies of Europe and the U.S. remain sluggish could be mitigated by completion of the trade agreement with India and expansion of exports to other fast growing developing countries.²⁰

A simpler trade regime has the potential to improve the trade balance. Continued exchange rate flexibility will also be important to maintain macro stability (including rebuilding international reserves) and to maintain competitiveness. The Central Bank's announcement in February 2012 that it will reduce intervention in the foreign exchange market is a positive sign.

19 Recent analytical work finds that the two main constraints to labor productivity in Sri Lanka are: (i) low competition with foreign firms (i.e. insufficient incentives to produce efficiently) and (ii) low share of investment financed externally (i.e. insufficient exposure to state-of-the art global knowledge). See Dutz and O'Connell (2011), "The Business Environment, Productivity and Innovation in Sri Lanka: An Empirical Exploration".

20 Sri Lanka relies heavily on European demand for its merchandise exports as well as service exports (tourism). Thirty five percent of goods exports go to Europe and 37 percent of tourist arrivals come from Europe.

21. **Sri Lanka's fiscal balance and debt situation is expected to continue to improve, assuming continued efforts to enhance revenues, reign in expenditures and strengthen debt management. The medium term fiscal framework relies heavily on revenue growth.** There is considerable room for revenue growth, given that current levels (about 16 percent of GDP in 2011) are low by international standards and compared to levels achieved in the 1980s (about 23 percent of GDP). Important reforms were enacted last year, simplifying the tax regime and broadening the base, in an effort to increase revenues. Persistent inefficiencies in tax collection and widespread tax evasion, however, have meant that revenues have been slow to rise. Progress is expected going forward as the tax administration is modernized.²¹

Expenditures are expected to remain flat as a share of GDP despite pressure to increase public investment on infrastructure and to increase the remuneration of civil servants. Continued efforts to increase efficiency of public spending, including improving value-for-money from public procurement and management reforms in SOEs, will be essential. Government plans to improve the flow of reliable and timely information on budgets and outcomes are expected to improve the quality of budgetary decision making

21 An ongoing project financed by the Asian Development Bank is computerizing tax records and collection procedures.

and confidence in sound policy making. Interest payments on public debt continue to absorb more than a third of recurrent expenditure.²² Despite its improved sovereign credit rating, Sri Lanka is vulnerable to increased costs of borrowing because overall debt remains high.²³

22. **Inflation is expected to remain moderate over the CPS period.**²⁴ The increased cost of imports (due to a weaker rupee) is expected to be offset by lower domestic food prices (thanks to increased production). Risks to inflation remain, however, if investment does not increase fast enough to avoid an overheating of the economy.

22 Interest expenditure accounts for a one third of total recurrent expenditure. Yield rates on government short to medium term securities having risen considerably since the third quarter of 2011.

23 Costs of borrowing could rise if improvements in the sovereign credit rating were reversed or if international credit markets contracted as a result of ongoing problems in Europe.

24 In the near term, inflation could increase. The Government raised retail prices of gasoline, diesel and kerosene by 9 percent, 38 percent and 49 percent respectively in February 2012. In addition, electricity fuel surcharges were also raised between 15-40 percent in February (to take into account increased cost of thermal power generation) while transport fares in the privatized bus companies were also increased by 20 percent. These one-time increases in energy prices are expected to result in increases in food and other products over the coming months.



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country vision, achievements and challenges

23. **The Mahinda Chintana Vision for the Future lays out the Government's vision for development over the period of 2010 to 2016.** The Mahinda Chintana describes three goals. The first is the doubling of per capita income between 2009 and 2016 to be achieved through sustained high economic growth, driven by a high investment rate. Second is the shifting of the structure of the economy to be more knowledge-based, globally integrated and competitive, environmentally friendly, internally integrated and increasingly urban. Third is ensuring improved living standards and social inclusion.

The Government's vision aims to double per capita income through investment

A. DOUBLING PER CAPITA INCOME THROUGH INVESTMENT

24. **The Government's Vision, lays out a consistent set of macroeconomic goals.** In particular, the Mahinda Chintana seeks to double per capita income, to about US\$ 4,000 between 2009 and 2016. Accomplishing this will require about 8 percent GDP growth, which would in turn require investment of 33-35 percent of GDP per year.²⁵ The Government plans include public investment of 6-7 percent of GDP, as the maximum affordable given the fiscal and debt situation. The remaining investment would need to come from the private sector.

25 Achieving this level of per capita income by 2016 is consistent with assumptions for annual population growth of 1 percent, annual inflation of 2 percent and an annual appreciation of the rupee against the dollar of 1.6 %.



Rapidly moving Colombo's infrastructure forward



Making city development a sustainable process

25. **While the growth target was met for 2010 and 2011, as a result of the post conflict rebound, sustaining this growth will require a substantial increase in investment. Public investment came close to the target in 2010 and 2011, at 5.8 and 6.0 percent of GDP respectively.**²⁶ The main challenge in this regard will be sustaining the high rate of public investment over the medium term given the tight fiscal space. The Mahinda Chintana proposes to bring the fiscal deficit to 5 percent of GDP by 2013 and maintain it at that level over the medium term. This goal is achievable but will require significant effort on both revenues and expenditures. At about 16 percent of GDP in 2011, revenues are low by international standards and well below the 23 percent Sri Lanka had in the 1980s.²⁷

The budget for 2011 simplified and reduced taxes and broadened the base, in the hopes that this will boost receipts. Further tax regulation changes could enhance incentives for productive investment and reduce distortions. In addition, increased efficiency in tax collection and improved efforts to address the tax evasion are needed if revenues are to reach the targeted levels for 2012 and beyond.

26 Public investment numbers provided are capital investment numbers as reported by the Central Bank of Sri Lanka.

27 This decline is mainly attributed to the gradual removal of export related taxes, which was a significant source of revenue until the end of the 1980s.

While revenues have been low, expenditures have been high (about 22 percent of GDP in 2011) due to the high level of investments in post war reconstruction and infrastructure modernization, transfers to loss-making State Owned Enterprises, a large wage bill and high interest payments on debt. The Mahinda Chintana identifies several important governance-related opportunities to increase efficiency of public spending. These include establishing a clear system for assessing costs and benefits of investments, reforming management and improving efficiency of State Owned Enterprises²⁸ and improving the flow of budget information.

28 Off budget financing activities are relatively low and loss-making state enterprises are financed mostly by direct transfers from the budget. The bulk of state-owned enterprise debt is from Ceylon Petroleum Corporation and Ceylon Electricity Board. Efforts are ongoing to try to help these enterprises break even. However, these enterprises and the country public finances will remain vulnerable unless Sri Lanka implements a price-setting mechanism that allows the full recovery of input prices. The recent revisions in energy prices are a positive move in this direction. The banking system poses modest contingent liabilities to the government, with adequate capitalization ratios and improving nonperforming loans. The Mahinda Chintana states that all SOEs will develop corporate mandates, all Board members will enter into performance contracts, and all SOE activities will be disclosed to the public by adopting a sound reporting system based on international best practices.



Promoting a healthy body for a healthy mind

Improvements in efficiency will also require continued efforts to improve financial management and procurement practices and to improve alignment of available resources of provincial and local authorities with the mandates they have been given. Sri Lanka's ability to borrow to finance public investment has improved since the end of the war thanks to increased creditworthiness, as reflected in sovereign credit ratings. Nevertheless, borrowing costs could increase if there are problems in the international financial markets (e.g. related to the Eurozone crisis) or if credit ratings are not maintained.

26. **Private investment has fallen far short of the amount needed to sustain growth.** With private investment at 22 percent of GDP in 2010, total investment reached only 26 percent of GDP – far below the required 33-35 percent. Foreign Direct Investment has also been disappointing. Foreign Direct Investment is not only important for increasing total investment but also as a key source of global knowledge and technology.

Achieving the private investment target will require concerted efforts to improve the investment climate. The World Bank Group's Doing Business Indicators have identified areas of weakness including enforcing contracts, paying taxes, registering property, and obtaining construction permits. An interagency committee has been following up on reforms in these areas with the aim of achieving a 30th place ranking in Doing Business.



Securing the safety of rural dams for better irrigation management

A recently conducted survey of Sri Lankan businesses indicates that the biggest obstacles faced are access to finance, taxes, unfair advantages of the informal sector,²⁹ the formal/informal sector dichotomy, electricity, labor force skill mismatches, and access to land.

The Government's vision aims to ensure that all social groups benefit from growth

²⁹ The formal or registered companies are perceived to be adversely affected by the informal or unregistered companies since they are not required to obtain various regulatory approvals and can evade taxes and also avoid maintaining accounts.

country vision, achievements and challenges Contd...

B. SHIFTING THE STRUCTURE OF THE ECONOMY

27. **Sri Lanka has a generally well educated population for its income level, but faces challenges in becoming a knowledge-based economy.** Sri Lanka does well in terms of access to education and completion rates.³⁰ At the same time, however, employers complain that they are unable to find workers with the needed skills – especially information technology, English language, and soft skills (e.g. problem-solving skills, good communication and ability to work in teams). Although efforts have been made to introduce these skills into the curriculum, the emphasis on testing factual knowledge in the assessment system has meant that few resources are spent on the new skill curriculum. Moreover, addressing the knowledge-economy will require creation of a dynamic system in which curriculum focuses on higher level cognitive skills and a feedback mechanism to adjust to changes in the needs of the labor market.

30 Primary completion rates are above 97 percent and secondary school enrollment is over 85 percent.

In addition, in light of the long-lasting impacts on both cognitive and non-cognitive skills, early childhood education needs attention. Keeping up with technology will be a particular challenge: information and communications technology adoption is identified as a weakness in both the Global Competitiveness Index³¹ and the Global Innovation Index. According to the Telecom Regulatory Commission, internet use at 12 percent of the population in 2010 is below the average for countries at Sri Lanka's income level.

28. **The Mahinda Chintana aims to increase Sri Lanka's integration into the global economy and make it competitive internationally.** Historically, Sri Lanka has been well connected internationally, making use of its excellent climate and strategic geographic position between the west and the east, and was considered the most open economy in South Asia. Over the past decade however, Sri Lanka has become less competitive, with the exports declining from 39 percent of GDP in 2000 to 17 percent in 2011.

31 The Global Competitiveness Index measures the speed with which an economy adopts existing technologies to enhance the productivity of its industries, with specific emphasis on its capacity to fully use ICT in daily activities and production processes for increased efficiency and competitiveness.

country vision, achievements and challenges Contd...

Although the high-end apparel sector has performed well and the number of tourist arrivals has increased dramatically since the end of the conflict,³² several challenges remain. The tourist industry competes with other destinations that offer very high value for money.

High tech exports represented less than one percent of manufacturing exports in 2010.³³ Sri Lanka's high exchange rate has hurt export competitiveness, particularly as the currencies of several nearby countries have devalued in the past year.³⁴ The agricultural export sector (including tea, historically a main export) operates well below potential due to low productivity; and complex, frequently changing, anti-export trade and pricing policies.

In terms of the Logistics Performance Index, Sri Lanka ranks below the regional average, reflecting poorly developed railways and congested access to major ports, as well as problems in customs clearance times, logistical competence, and the ability to track shipments. The Government strategy aims to reverse these negative trends and make Sri Lankan exports highly competitive.

32 Tourism receipts increased from US\$ 380 million in 2008 to US\$ 576 million in 2010 to about US\$ 800 million in 2011.

33 World Development Indicators.

34 Unfolding events in Europe caused a retreat out of developing countries and into "safe haven" U.S. assets. As a result, currencies of Bangladesh, India, Pakistan, and others around the world depreciated sharply against the dollar.

29. **Sri Lanka has a wealth of environmental assets, boasting the highest biodiversity per square kilometer in Asia.** During the conflict, the slow pace of economic development meant that degradation was slower than it otherwise might have been. Mahinda Chintana goals for 2016 include raising forest coverage from 23 percent to 35 percent of the land area.

Despite official recognition of the importance of protecting environmental assets, the country's performance on environmental sustainability has not been fully satisfactory. In fact, Sri Lanka risks losing many of its assets and biodiversity, as demonstrated by a recent survey that found that 33 percent of fauna and 61 percent of flora are threatened. 35 percent of old growth forest cover has been lost since 1990 – among the highest in the region – further increasing the challenge of meeting Government targets. Moreover, environmental neglect can directly and indirectly impact economic performance, and the rate and sustainability of long term growth.



Weighing the best options for childcare



Feeding the right information on nutritious living

30. **For generations, Sri Lanka's population has been more internally mobile than most countries, on account of the extensive network of roads, buses and railways and relatively compact geographic territory.**³⁵ During the war, much of this infrastructure was damaged and attention was not given to modernizing or even maintaining the infrastructure. Today, road travel within the country is very slow with average speed of only 26 kilometers an hour.

A massive effort is currently underway to bridge the infrastructure gap, using domestic budget as well as support from the multilateral and bilateral community. The country's first expressway opened in 2011, halving travel time from Colombo to Galle. Nevertheless, challenges remain.

More needs to be done to understand and enhance the economic connections across the country to take advantage of forward and backward linkages in supply chains and of distinct comparative advantages of different parts of the country.³⁶

35 As of 2010, there were 1.7 km of road per km² and 97 percent of villages are reached by the road network. As of 2000, 86 percent of the roads were paved.

36 Based on current trends of urbanization and policies that support private vehicle ownership over mass transit, congestion rates are expected to increase dramatically over the coming decade. By 2031 travel speed is expected to decline to 19 kilometers an hour, with rush hour in Colombo District falling to below 9 kilometers per hour.

C. IMPROVED LIVING STANDARDS AND SOCIAL INCLUSION

31. **Mahinda Chintana aims to ensure that all social groups benefit from the growth envisaged above.** With a long history of attention to access to basic services, Sri Lanka excels for its income level on most social indicators. This includes life expectancy, education, births attended by a skilled professional, access to improved water source, and other key indicators.

32. **Although Sri Lanka excels in most social indicators, malnutrition is a striking exception.** About 22 percent of Sri Lankan children under 5 are underweight, as against the 14 percent expected for Sri Lanka's income level. That malnutrition has persisted even as the GDP per capita has increased reflects the complexity of the problem. Tackling malnutrition will require a combination of actions involving healthcare, food security, water and sanitation, attitudes and behaviors.

country vision, achievements and challenges Contd...

33. **As Sri Lanka becomes a middle income country, new challenges emerge related to the interrelated phenomenon of increased wealth, changing age structure of the population and increasing urbanization.** As the population becomes wealthier, citizens expect a higher quality and wider range of services and lower waiting times. The type of services needed also evolves with the changing diseases and the aging of the population: the health system, for example, must build capacity to address non-communicable diseases associated with a wealthier, more urban lifestyle (e.g. chronic conditions like diabetes and traffic accidents) and with an older population (e.g. geriatric care).³⁷

The social security system needs to be made sustainable. And the population density associated with urbanization requires improved network services (e.g. mass transit and water and sewerage networks).

34. **While increasing the quality of public services is an essential priority, it must be achieved in a manner that is fair to all citizens.** Whereas post-conflict resettlement and reconstruction necessitates a focus on investments in the conflict-affected areas of the north and east, service quality modernization necessitates a national approach. As noted earlier in this document, pockets of poverty exist in various parts of the country.

The challenge for service quality modernization will be to establish consistent, countrywide standards to support needs based resource allocations.

³⁷ Sri Lanka has the oldest population age composition outside of the Eastern European transition economies. In two decades Sri Lanka's age profile will be similar to that of Europe and Japan today, but with much lower income to support the large number of elderly dependents.

country vision, achievements and challenges Contd...

35. **Similarly, social inclusion is a high priority in the Mahinda Chintana, including addressing issues of youth unemployment, equal employment opportunities for women, safety nets for the poor and vulnerable, economic opportunities for the disabled and the aspirations of Sri Lanka as a multi-ethnic and multi-lingual country.** As in all countries, social inclusion is a challenge that requires continuous effort and the Government is taking steps in this direction. The challenges going forward include advancing on the ethnic reconciliation agenda and implementing key recommendations of the Lessons Learnt and Reconciliation Commission. The World Bank will assist the Government to increase social inclusion through analytical and advisory work, as well as through specific operations and as a cross-cutting theme overall in the portfolio.

36. **The Mahinda Chintana emphasizes the importance of women in Sri Lankan society.** The Ministry of Labor is currently in the process of preparing a strategy to encourage women's employment opportunities. In the past women working abroad as maids has been the largest source of remittances, but there have been several cases of major physical and psychological abuse reported.

The Ministry of Foreign Employment Promotion and Welfare has shifted its emphasis and is now providing training programs and encouraging women to seek skilled jobs. Regarding women's nutritional status, the Government has introduced a nutritional supplement program for mothers and infants, which is well-targeted.



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A. LESSONS FROM THE CAS COMPLETION REPORT

37. **The design of CAS FY09-12 reflected country reality at the time it was written.** Appropriately, the CAS FY09-12 focused on maintaining basic services in the midst of conflict, with strong attention to the conflict-affected north and east and other lagging regions and strong use of Community Driven Development (CDD) approaches. Over the course of the CAS FY09-12, Sri Lanka's context changed and the program appropriately adapted to those changes. Of the 15 lending operations that were planned in the CAS, five were dropped and two transformed.

Meanwhile, four new projects were added and additional financing was provided for three projects. Of the 12 Analytic and Advisory Activities (AAA) that were planned in the CAS, three were dropped and two refocused. Meanwhile, four new AAA tasks were added.

38. **In many ways, the World Bank was successful in responding to the changing priorities.** The lending program responded to urgent needs – including resettlement and floods, while still focusing on the conflict and lagging regions. In other ways, however, the World Bank did not fully keep up with the changing issues.

Authorities have noted that the World Bank was overly focused on what the Government views as a 'low income country agenda', and could have moved support to the emerging middle income country agenda, with which the Government has less experience.

39. **The AAA program was small, and in some cases lacked a clear purpose and audience.** Dialogue on policy issues was underdeveloped in most sectors. This was due to two factors. First, counterparts were primarily focused on engaging the World Bank in infrastructure, rather than policy issues. Second, the World Bank did not keep up with core AAA products needed to monitor the evolving situation (e.g. analysis of public expenditures, public financial management and poverty).



Ensuring a continuous flow of fresh water throughout all communities



Furnishing the displaced with a place to call 'home' again

40. **Engagement in education and health was more successful than in other areas.** This success was due to several factors:

(a) the substantive focus was well-aligned with Government priorities; (b) interaction was sustained through a combination of lending and AAA used to inform the dialogue; (c) sector-wide, results-based approaches were introduced including support for strategic planning, monitoring and results-based disbursement; (d) interactions at both national and sub-national levels.

41. **The strategy of channeling resources through the banking system and of strengthening the alignment between IFC advisory services and investments worked well.** Sri Lanka possesses a sound banking system, which both the IFC and the World Bank used effectively to channel resources, for instance, to engage the private sector in sustainable energy generation and in transferring resources to SMEs during the economic slowdown. The lesson is that anchoring support on strong local institutions helps by-pass local capacity constraints.

In addition, in line with global guidelines, IFC's work on the ground stressed the alignment between advisory and investment activities. For instance, in projects such as support to the Dialog telecommunications company, the advisory intervention broadened the range of benefits and beneficiaries that are being supported.

42. **The last CAS committed to the use of a Conflict Filter to improve the peace and conflict sensitivity of operations.** It was meant to help task teams better understand the operating environment at both national and local levels, as well as possible drivers of the conflict through deeper analysis on institutions, stakeholders and benefits-sharing. The Conflict Filter analyses have been conducted for all new projects in the current CAS period. The Filter was revised during the CAS period to map it to the new Operational Risk Assessment Framework (ORAF), which was introduced across the World Bank.

43. **It takes longer-than-anticipated time for private sector investment to pick up in post-conflict markets.** Expectations for a rapid pick-up in private investments after the conflict ended proved to be optimistic. The corporate/private sector may not have felt comfortable to make investments until peace was firmly cemented, including an easing of tensions with the international community, and seeing how the new Government would rebuild the ground for the private investment.



New roads to new opportunities



A boom in infrastructure development

On the latter, the signals of the Government regarding its commitment to a positive investment climate for the private sector have been perceived as mixed by potential investors. The lesson that emerges is that in post-conflict countries stronger and unambiguous messages are needed to motivate a strong engagement of the private sector.

Going forward, continued attention to the quality of the broad business environment is needed to enhance the opportunities for the private sector support in the country.

B. FINDINGS FROM THE STAKEHOLDER SURVEY AND CONSULTATIONS

44. **Stakeholder surveys were conducted during the CPS preparation process to complement the World Bank's self-assessed CAS FY09-12 Completion Report.** A quantitative Client Survey captured views of 300 respondents. The survey findings support several of the conclusions from the CAS Completion Report. Although respondents perceived the World Bank to be more effective than it was when the survey was last conducted in 2007, respondents feel that the World Bank's focus has not been sufficiently aligned with Sri Lanka's current development priorities, notably middle income country issues. Respondents also indicated a need for an increase in the provision of knowledge and advice.

world bank group partnership strategy Contd...

45. **In addition to the quantitative Stakeholder Survey, in-depth interviews were conducted by an independent research company with key decision makers, government officials, private sector representatives and civil society leaders.** The interviews reinforced the conclusions from the quantitative survey. The World Bank is seen as an organization able to catalyze transformational change in Sri Lanka, through combined knowledge and financial resources. Respondents perceive the World Bank to be extremely rigorous in its processes – a quality that some see as beneficial, while others felt is overly cumbersome. Respondents feel that in recent years, the World Bank has focused its attention on financing rather than knowledge and could play a more proactive, visible role in Sri Lanka’s transformation.

46. **Consultations were held throughout the CPS preparation process.** A total of 18 consultations were conducted, involving more than 400 participants including development partners, youth, gender and environmental activists, the private sector, Members of Parliament, and officials from central, provincial and local government.

The consultations contributed to the diagnosis of Sri Lanka’s development challenges and provided an opportunity to obtain feedback as the strategy’s objectives, areas of focus, principles and rules of engagement emerged.

Recurring issues raised in the consultations include: the need to reorient publically provided infrastructure and services to the needs of an urbanizing, middle income country; the institutional and financial needs of local and provincial government to allow them to fulfill their mandates; the need for increased clarity and consistency of policy vis-à-vis the private sector; the need for continued attention to poverty and inequality; the role the World Bank is expected to play in wide dissemination of knowledge; and the importance of World Bank coordination with other development partners.

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C. ASSESSMENT OF THE CURRENT PORTFOLIO

47. **The portfolio is generally healthy with no major problems.** The current World Bank portfolio consists primarily of International Development Association (IDA) funded projects: the first International Bank for Reconstruction and Development (IBRD) loan was presented to the Board in March, 2012. As of March 31, 2012, the portfolio consisted of 14 projects with a total commitment of US\$ 1.068 billion³⁸ and a disbursement ratio of 17.9 percent (compare d to 15.8 for South Asia as a whole and 14.9 for the World Bank as a whole.) Sri Lanka has a high percentage of projects at risk³⁹ (21 percent), however measures are being taken to address these projects as reflected by the high proactivity index of 100 percent.⁴⁰

38 The first IBRD loan, the US\$ 213 million Metro Colombo Urban Development project, will bring the portfolio to 14 projects.

39 A project is considered “at risk” if it is not meeting its development objectives. It is the sum of actual problem projects and potential problem projects. A project is considered a problem project if implementation progress or the development objective is rated unsatisfactory in the latest project implementation status report. Disbursement ratio is defined as the ratio of disbursements during the fiscal year to the undisbursed balance at the beginning of the fiscal year. (Only investment operations are included in the calculation.) The net disconnect is defined as the difference between ratings given by the Internal Evaluation Group and those given by the Regions.

40 The proactivity index gives the percentage of projects rated as actual problem projects 12 months earlier than have been upgraded, restructured, suspended, closed or partially (20 percent or more of commitments) or fully canceled.

48. **The latest portfolio review held in October 2011 identified scope for further improvements in several areas including procurement⁴¹, monitoring and evaluation.⁴²** The overall financial management performance of the Sri Lanka portfolio is satisfactory and the fiduciary risk after mitigation is rated as “moderate” for the majority of projects. Risk in some projects have been rated as “high” and “substantial” based on the nature and complexity of implementation arrangements, weak implementation capacities of implementing agencies and due to their reliance on aspects of the country financial management systems that are still weak.

With the intention of the Government of Sri Lanka to promote the use of country financial management systems to the maximum extent, continued efforts are required to strengthen these systems.

41 With regard to procurement of the 13 projects, 5 were satisfactory, 8 were marginally satisfactory and 2 were marginally unsatisfactory.

42 Of the 13 projects, 10 were satisfactory, 4 marginally satisfactory and 1 marginally unsatisfactory.



Netting fresh yields

49. **The World Bank Group program made significant use of trust fund resources during the FY 09-12 CAS period, supporting both analytical work and technical assistance.** Trust funds have supported activities in a range of areas, from technical assistance on Public Private Partnerships for infrastructure development, to avian influenza preparedness, to renewable energy. Trust funds have significantly bolstered post-conflict and reconstruction efforts, including considerable Australian support for the cash-for-work component of the Emergency Northern Recovery Project and the Japan Social Development Fund support for nutrition in the Northern Province. They have also afforded meaningful support for the Government's efforts to reform its main safety net program, Samurdhi, as well as for undertaking critical post-disaster needs assessments and expanding access to finance for poor women.

Commitments from trust fund resources over the FY09-12 CAS period have amounted to US\$ 42.2 million, over 39 World Bank operations. IFC's private sector development support benefited from donor support, including Norway for the Sri Lanka Development Facility, and The Netherlands-IFC Partnership Program and DevCO for the South Asia Infrastructure Facility.



A smoother ride to the North & East once again

Global Environment Facility-backed PADGO (Portfolio Approach to Distributed Generation Opportunity) is also supported by Japanese and Irish funds. Recently, the European Union and IFC have strengthened their partnership, and the first such initiative has launched to benefit four post-conflict districts.

50. **A performance review of the eight ongoing recipient-executed trust-funded activities identified several areas for increased attention.** Among the issues identified are delays in effectiveness and implementation, lack of attention to results monitoring and evaluation, and high transaction costs for both the Recipient and the World Bank. A specific risk associated with the trust fund portfolio has been the limited institutional capacity of recipient institutions and the over-burdening of implementing agencies with the administration and management of small stand-alone trust funds. This has sometimes resulted in lack of compliance with fiduciary requirements, as in the case of the small post-conflict grants.



Constructing new lives and livelihoods across the land



Giving budding new enterprises room to grow

51. **IFC's portfolio is generally performing well and weathering the global economic challenges well.** Two underperforming investments are being monitored closely. IFC's ability to advise Government agencies on structuring and tendering projects and to fund infrastructure is constrained by limitations in the rules and competitive bidding process currently in place.

This CPS provides support to address the challenges facing the Government's vision

D. PRINCIPLES AND RULES OF ENGAGEMENT

52. **Reflecting on the dialogue with the Government counterparts, consultations with stakeholders, and the CAS FY09-12 Completion Report, the World Bank Group has agreed on several principles and rules of engagement to guide the new CPS.**

53. **Focus will be placed on the middle income country agenda.** For many years, Sri Lanka has served as an international role model in terms of access to basic services. As Sri Lanka moves into middle income country status, a new set of issues has emerged. Such issues include the fiscal and social impacts of the demographic transition, the Government's role as facilitator/regulator of the private sector as well as direct provider of services, and alignment of roles and resources of provincial and local authorities.

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Building on the World Bank's comparative advantage in analytical work and as an institution working in a wide range of middle income countries, the World Bank will increase its efforts to identify the various options taken by other countries in the transition, to connect Sri Lankan practitioners with their counterparts from other countries.

54. **The 2011 World Development Report (WDR) on Conflict, Security and Development provides valuable insights and lessons for this CPS.** Sri Lanka emerged from 26 years of conflict in 2009; however it is important to note that it is not a standard post-conflict, fragile country that experienced a substantial breakdown in institutions. Even during the conflict, the public sector continued to function, providing increasingly better services, fostered substantial economic growth and the poverty conditions improved.

Nevertheless, many of the principles of engagement proposed by the WDR are relevant for Sri Lanka: enhancing political and economic inclusion, delivering early results to build public trust and confidence, focusing on social accountability tools, applying community-driven approaches, and strengthening institutions in a phased approach. This CPS, as well as the past CAS, encompasses these principles. For example, under the last CAS and continuing during this CPS, the World Bank has supported the Government's rapid effort to resettle families dislocated by the conflict.

This resettlement has helped build confidence in Sri Lanka going forward. On-going projects in the portfolio will continue to support building livelihoods and social capital among the resettled communities through a CDM approach. The CPS addresses social accountability through support to Parliamentary oversight committees, works with and strengthens all tiers of Government, and emphasizes broadly shared benefits of growth.

55. **The CPS is designed to be flexible.** The present document includes an indicative pipeline, which will be modified and supplemented during the CPS period. The World Bank Group will use the CPS Progress Report to review alignment of the project /AAA portfolio with evolving country needs and Government priorities and to modify the program accordingly.

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56. **Increased attention will be paid to results in all sectors.** Building on successful approaches in the education and health sectors, the World Bank will move toward increasing emphasis on results in all sectors. AAA will be used to identify the driving forces and key constraints to inform projects design. Results will also be emphasized in the formation of teams: it is anticipated that teams will increasingly need to include staff from more than one sector, and often including both the World Bank and IFC.

Recognizing the difficulties inherent in this work, the Country Management Unit will play an active role in defining tasks around results and providing appropriate incentives and accountability.

57. **The Government systems will be used whenever possible and strengthened.** Over the upcoming CPS period, increased use of country systems is expected as capacity is built in line ministries and provincial and local governments. Where separate the World Bank systems need to be maintained, efforts will be made to reconcile the systems and build capacity. In financial management, the World Bank will agree with the Government on steps to increase the use of country financial management systems during the CPS period.

Support to the strengthening of public audit to enhance the scope and coverage of public audits and to strengthen value added audit services will continue. Re-engaging in activities to strengthen Parliamentary oversight of public funds is also expected during the CPS period.

In procurement, the recent portfolio review and procurement assessment have identified scope for improvement. During the CPS period, fiduciary reviews will be conducted with an emphasis on improving the capacity to implement procurement in accordance with the national procurement legislation.



Keeping a close eye on nourishment



Maintaining the beauty of the coastline to bring in new waves of tourism

The World Bank is also working toward mainstreaming project implementation in existing agencies, and move away from stand-alone Project Management Units, consistent with Government's Management Circular 33. For example, in the recently approved Metro Colombo Urban Development Project, while a stand-alone Project Management Unit has been established, its mandate is limited to fiduciary issues and it is comprised of civil service staff temporarily released from their normal duties and paid salaries based on a regulated scale.

58. **The pipeline will focus on a small number of large projects.** Given that the Government is engaged in a major effort to modernize infrastructure and institutions, human capacity in Government agencies is being stretched by high transaction costs. Similarly, World Bank resources for both analytical work and lending will be stretched given the flat budget environment to support increasing lending. Under this CPS, lending will be through few, larger operations. This allows efficiency in delivery and focus on identified priorities of the Government.

59. **Lending activities and dialogue will involve all relevant tiers of Government.** This approach builds on the successes of the previous CAS in supporting capacity building at local, provincial and central levels in projects including North and East Local Services Improvement, Higher Education for the Twenty First Century, Provincial Roads, and the Health Sector Development Project.

60. **Safeguards provide opportunities to support the Mahinda Chintana vision.** For example, the World Bank will seek opportunities for projects to actively contribute to the Mahinda Chintana goal "to promote sustainable development in close liaison with the land, fauna and flora and to bestow our natural heritage to our future generation." This approach will include efforts to maximize the environmental benefits of projects and to protect investments through integrated disaster risk management. Similar efforts will be made on other safeguards as well.

61. **Analytical and advisory activities will be used strategically to support the CPS areas of focus.** All potential AAAs will have clearly defined purpose and audience. AAA will be used to inform planned lending activities, to support dialogue in key policy areas where no lending activities have been planned and to fill gaps in the World Bank Group's own knowledge, and due diligence.



Powering up rural communities for a better tomorrow



Passing on the right nutritional values

62. **Increased attention will be paid to communication.** In addition to requesting the World Bank to provide more analytical work, respondents in the Stakeholder Surveys requested the World Bank to play a more visible and active role in broad knowledge dissemination and stimulating public debate on development issues. Going forward, consistent with the Access to Information Policy, the World Bank will increase the attention paid to dissemination of the messages of analytical work to a wide audience including Government counterparts, Parliament, think tanks and others.

Increased attention will also be paid to communication with the media. Greater emphasis will be placed on translating materials into Sinhala and Tamil and communicating with the Sinhala and Tamil media.

E. COUNTRY PARTNERSHIP STRATEGY AREAS OF FOCUS

63. **This Country Partnership Strategy provides support to address the challenges for achieving the three main goals of the Government's Mahinda Chintana Vision for the Future. For each of the three central goals of the Government's vision, the CPS lays out the key areas of engagement in which the World Bank Group support can most effectively address the challenges identified in the Section II of this document.** In particular, the CPS focuses on specific topics of the World Bank comparative advantage, with an emphasis on the middle income country agenda, the role of the private sector, and institutional and policy issues, and ensuring broadly shared benefits of growth. The CPS is organized as follows:

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Area 1: Facilitating sustained private and public investment

- A: Improving the investment climate
- B: Increasing fiscal space and the efficiency of public spending

Area 2: Supporting structural shifts in the economy

- A: Supporting the shift to a knowledge based economy
- B: Boosting international integration and competitiveness
- C: Supporting the internal integration of the economy

Area 3: Improving living standards and social inclusion

- A: Increasing quality of services
- B: Reducing the prevalence of malnutrition
- C: Expanding social inclusion and equitable access

world bank group partnership strategy Contd...

64. **IFC's focus areas during FY 13-16 will be fully aligned with the CPS and will be consistent with IFC's Regional Strategy in South Asia, which emphasizes:**

- (a) Inclusive Growth
- (b) Climate Change
- (c) Regional/Global Integration

While all of the three pillars support Area 1 of this CPS, the inclusive growth emphasis focuses on making an impact on the base of the pyramid, low income households through access to finance, infrastructure, social services and markets. This focus especially supports the outcomes set in the Areas 2 and 3 of the CPS described.

The climate change emphasis supports renewable energy (hydro, solar, biomass, and wind), energy efficiency, and agricultural and irrigation efficiency activities, which are expected to result in reduced carbon footprints. This focus is aligned with Area 2. Finally, to promote integration, IFC supports South-South investments, knowledge transfer, improvements in the investment climate, and trade and logistics. This focus is in line with Areas 1 and 2 of the CPS.

Area 1: **FACILITATING SUSTAINED PRIVATE AND PUBLIC INVESTMENT**

65. **The first CPS area, facilitating sustained private and public investment, provides support to the Mahinda Chintana goal of doubling per capita income through sustained growth.** The main challenges to achieving this goal relate to increasing private investment and making public investment sustainable.

Area 1A : **Improving the investment climate**

66. **The World Bank Group will support the Government's efforts to improving the investment climate.**⁴³ The Government has requested financial assistance to support regulatory aspects of investment climate reforms. Potential areas for engagement include improving the business environment, enhancing investor confidence, and business-related legal and judicial reforms. The requested assistance is likely to include a multi-sector Development Policy Loan and an Investment Loan supporting the legal and judicial sector.

43 Improvements in the investment climate will not only help increase total investment but also encourage foreign direct investment – a key source for global knowledge and technology.



Creating higher living standards in urban areas



Preserving the marshes to balance the city's eco system

67. **An enterprise perception survey of Sri Lankan firms was conducted in 2011 to gauge the constraints hindering the performance of firms.** The findings of the survey revealed that the major constraints encountered by firms are access to finance, informal practices by firms, electricity and tax rates. The World Bank Group will continue to provide support to the Doing Business Committee (convened by the Central Bank and chaired by the Minister of Economic Development) as it facilitates the implementation of priority reforms. In particular, trust fund resources will be sought to connect relevant agencies to their counterparts in countries that have worked on similar reforms through a South-South Knowledge Exchange and other mechanisms. Trust fund resources will also be sought to provide support to development of the capital market for financial sector deepening and improving access.

Ongoing projects include the Small and Medium Enterprise Development Facility (improving access to finance for Small and Medium Enterprises affected by the global financial crisis), the Sustainable Tourism Project (supporting environmentally and socially sound investments in tourism) and the Warehouse Receipts Trust Fund (providing farmers with access to storage and collateral needed for access to finance).

68. **The World Bank will continue its support to the increased adoption of International Financial Reporting Standards (IFRS) and International Audit Standards in the private sector.** Well defined standards and practices in Financial Reporting and Auditing in enhancing the quality of corporate governance and ability of the country to attract foreign investments will be critical.

Following up on the recommendations of the Report on the Observation of Standards and Codes for Accounting and Auditing (ROSC A&A) diagnostic carried out by the World Bank (2004), support is being provided to the Institute of Chartered Accountants Sri Lanka through an Institutional Development Fund grant for enabling the adoption of International Financial Reporting Standards to small and medium enterprises and State Owned Enterprises as well as for improving the quality of audit practices. Support will be provided to oversight institutions like the Sri Lanka Accounting and Auditing Standards Monitoring Board that will help to improve the transparency and accountability in the private sector.

Considering the changes and improvements that have happened internally and externally since the last ROSC A&A Report for Sri Lanka; an update of the diagnostic is planned to facilitate targeted support to emerging areas relating to the strengthening of corporate governance and financial management in the private sector.

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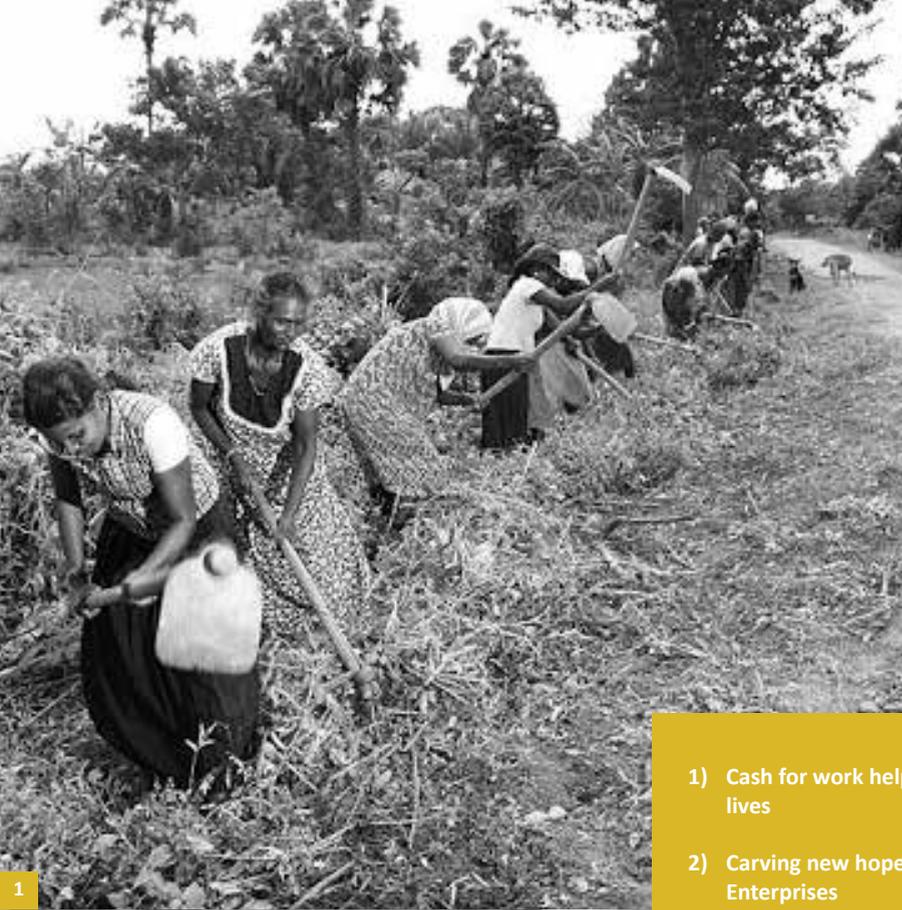
69. **Through its investment and advisory products, IFC will seek to promote private sector investment and work with the World Bank and the Government on the related agenda.** To help Sri Lanka maintain strong economic outlook despite expected slow growth in the global economy in at least the initial part of the CPS period, it is critical to improve the investment climate by facilitating Government efforts on the comprehensive framework and fair rules to enable increased participation by the private sector.

Complementing the World Bank's support for legal and judicial reform, IFC plans to support the supply side by promoting transparency in the private sector and helping to clarify the private sector's role, which can increase investor comfort level. In addition to supporting Doing Business, IFC will look for opportunities to improve regulations that constrain the financial sector, tourism and agribusiness.

IFC will also seek to catalyze investments through directly investing in important projects in key economic sectors including the financial sector, tourism, agribusiness and infrastructure. IFC's advisory program will expand its support for firm level capacity building in priority sectors.

Capacity building in the financial sector will facilitate increased access to financial services for micro, small and medium enterprises as well as promoting low carbon growth. In the tourism and agribusiness sectors, IFC will also combine investment and a range of advisory activities – promoting sustainable practices, supply chain strengthening, particularly for small and medium enterprises, and regulatory improvement.

To promote competitive and sustainable business practices, all IFC investments will provide assessment and advice on environmental and social standards and require IFC's Performance Standard to be met. IFC also provides a corporate governance analysis of clients as a part of a new investment due diligence and will explore possibilities of providing more programmatic corporate governance assistance.



- 1) Cash for work helps restart their lost lives
- 2) Carving new hope into Small & Medium Enterprises
- 3) Tourists get a better view of Sri Lanka in her post-war glory
- 4) Creating self-reliant work opportunities



world bank group partnership strategy Contd...

Area 1B: **Increasing fiscal space and the efficiency of public spending**

70. **The World Bank will support the Government's efforts to maintain the high levels of public investment in a sustainable manner.** As a first step, the World Bank will provide analytical support in the form of a Public Expenditure Review (PER), which will examine budget allocations across sectors, contingent liability issues related to State Owned Enterprises, the extent to which revenue policies are achieving their objectives, and a Public Expenditure and Financial Accountability report (PEFA) that will examine the performance of budget formulation and execution process and which will benchmark Sri Lanka against other middle income countries.

AAA will also be provided to outline alternative financing arrangements for public infrastructure and services (including Public Private Partnerships) and the pros and cons of the various options. An existing activity, "Building Media and Civil Society Capacity for Budget Transparency" is supported by the Social Development Civil Society Trust Fund.

A proposed Development Policy Loan is expected to include aspects of public financial management, building on the engagement begun during the CAS FY09-12 and including increasing efficiency of public spending in line ministries and State Owned Enterprises, as well as aspects of the investment climate (as described in paragraph 69).

71. **Following up the public private partnership workshop organized by the World Bank Group in December 2010, IFC is prepared to continue to collaborate with the World Bank and Government partners to further develop a competitive Public Private Partnership framework in Sri Lanka.** This would include supporting the Government in structuring specific PPP projects and bidding these on a transparent, competitive basis in line with international best practice. This would help free up public sector resources and ensure that Sri Lanka benefits from private sector efficiency and cutting-edge practices.



A spiritually centered metropolis



Infusing technology into education to better prepare students

Area 2: **SUPPORTING STRUCTURAL SHIFTS IN THE ECONOMY**

72. **The second CPS area supports the Mahinda Chintana goal of shifting the economy to be more knowledge-based, globally integrated and competitive, internally integrated, increasingly urban and environmentally friendly.**

Area 2A: **Supporting the shift to a knowledge based economy**

73. **The World Bank will support the Government's efforts to shift toward a knowledge-based economy.**⁴⁴ In addition to the ongoing lending activities on Higher Education for the Twenty First Century, the E-Sri Lanka project, and the Trust Fund for Information and Communications Technology Regulatory Capacity Building, two additional lending activities have been requested. The proposed skills development project aims to enhance the relevance of training programs for the needs of the labor market. AAA task on skills development and another specifically examining skills training for women are ongoing and will support preparation of this project. The proposed innovation and research project aims to encourage private sector innovation and technology adoption.

⁴⁴ Sustained long term growth will require increases in productivity as well as increased investment. Education is important not only for direct increases in productivity but also as a prerequisite for innovation and technology adoption.

AAA on middle income approaches to innovation and technology adoption will be conducted in advance of project design. IFC seeks to continue to provide support in this area through capacity building for financial institutions and skills training in partnership with companies to strengthen the performance of SMEs.

IFC will continue to introduce innovative products to improve funding flows to Sri Lanka, such as a diversified-payments loan committed in FY12. These products can help lower the cost of financing for financial institutions and their customers, thus boosting competitiveness.

Area 2B: **Boosting international integration and competitiveness**

74. **The World Bank Group will support Sri Lanka's international integration and competitiveness through AAA activities.** These activities include an analysis of policy options for improving the trade balance and an analysis of Sri Lanka's potential to become an international hub for naval, aviation and commercial services. IFC will seek opportunities to support South-South investments into and from Sri Lanka and help catalyze foreign investments.



Rebuilding a nation's access to better living



Opening up new paths to success across the country

Area 2C: **Supporting the internal integration of the economy**

75. **The World Bank Group will support the Government's efforts to enhance Sri Lanka's urban areas and support internal integration.** A proposed project would provide a package of investments which would support economic connectivity and provide infrastructure services appropriate for rapidly growing secondary cities. Analytical work to better understand economic drivers and connectivity with the national economy will be conducted to help inform project design.

In addition, IFC is currently preparing an economic development project to be funded by the European Union, complementing the World Bank's support for in-country integration.

The project, also supporting Area 3, is designed to focus on four conflict affected districts of Mannar and Vavuniya in the north and Batticaloa and Ampara in the east, improving the business environment, local employment and micro and small enterprise development.

76. **The Mahinda Chintana advocates for an environmentally friendly economy.** The World Bank will continue to engage in this area, seeking opportunities to support the mutually reinforcing aspects of economic growth and environmental sustainability as well as ensuring compliance to environment-related safeguards. Although no new financial assistance has been requested, the World Bank would be prepared to provide financial support if needed in this sector.

The ongoing AAA on Mainstreaming Disaster Risk Management looks to strengthen Sri Lanka's early warning system and the capacity of Government to assess risks, integrate disaster risk reduction into the planning process and prepare post-disaster assessments.

The World Bank will continue to strengthen the institutional framework for environmental and socially sound investments especially in the East, including training eco-tourism guides and matching grants for reduction in carbon emissions. Building on its sustainable energy risk sharing facilities and direct financing for wind power generation, IFC will support projects that address climate change issues, such as renewable energy, cleaner production and energy efficiency.

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Area 3: **IMPROVED LIVING STANDARDS AND SOCIAL INCLUSION**

77. **The third CPS area is to support the Mahinda Chintana goal of improved living standards and social inclusion and equitable access.**

Area 3A: **Increasing quality of services**

78. **The World Bank will support increasing the quality of services.** A national health sector program, currently under preparation, will improve the quality of services provided throughout the country and modernize the Government managed health system.

The loan will specifically address the health care quality improvements required to address non-communicable diseases and will support modernizing the health system. The loan will be complemented by already ongoing AAA on the role of the private sector in health care in Sri Lanka and the recently concluded AAA on chronic and non-communicable diseases.

The program is expected to be presented to the Board in FY13 and have disbursements linked to key results. In addition, the Government has requested financial support for the transportation sector and for urban infrastructure (including water systems and solid waste management). Analytical work on options for internal transport is ongoing. Early childhood education will be assessed and reviewed through AAA in preparation for a lending operation. Ongoing activities include support to education and transportation and improved local service delivery in the conflict-affected North and East.

Area 3B: **Reducing the prevalence of malnutrition**

79. **The World Bank will aim to support reducing the prevalence of malnutrition, a key human development area in which Sri Lanka lags behind its peers.** In addition to the nutrition component of the health program, new multi-sector AAA work will be carried out and will build on existing analysis to identify policies for addressing malnutrition, including links to water supply and hygiene. Further engagement in the form of technical assistance or lending may be developed based on the analysis. In the meantime, the trust fund activity “Local Level Nutritional Intervention for the Northern Province” fosters changes to improve nutrition outcomes in resettled populations of the Northern Province.⁴⁵

⁴⁵ This activity is supported by the Japan Social Development Fund.

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Area 3C: **Expanding social inclusion and equitable access**

80. **Support for equitable access to public services and social inclusion includes activities specifically focused on conflict-affected areas as well as activities which address these issues at the national level.** Activities focused on conflict-affected areas include; the Community Livelihoods in Conflict Affected Areas project, the Emergency Northern Recovery project, and the trust fund supported North and East Pilot Water, Sanitation and Hygiene project for post conflict resettlements.

As the focus shifts from post-conflict reconstruction to an emphasis on equitable access and social inclusion across the entire country, new activities will seek to analyze and address inequities using a more systemic and sustainable approach. Activities which address equitable access and social inclusion at a national level include:

- (a) the Second Community Development project
- (b) a Poverty and Inequality Assessment
- (c) a trust fund on economic integration of vulnerable groups
- (d) a Poverty and Social Impact Analysis on the potential effects of various policy options on employment of women
- (e) technical assistance to the Ministry of Labor on their gender strategy

- (f) technical assistance on the Government's social protection strategy and Samurdhi program
- (g) vocational training for the disabled
- (h) pilot approaches to sustainable, affordable sanitation services to under-served low-income groups
- (i) work with youth organizations to support their involvement in development issues



Educating communities on healthier ways of living



Preparing the rural youth to thrive in an IT savvy future

81. **IFC will seek to help improve living standards and social inclusion especially through support for access to finance, infrastructure, agribusiness and farmers (particularly in post-conflict northern and eastern regions), and micro, small and medium enterprises.** Mindful of the post-conflict and transition state of the country, IFC has been increasingly supporting some of these areas in Sri Lanka in recent years and will build on those experiences to enhance the reach and impact for inclusive growth. For example, microfinance projects have been promoting women's financial inclusion and an agri-business advisory project, supported by a multi-donor Global Index Insurance Facility, is building on pilots in other developing countries and helping create a weather-index based crop insurance to support farmers.

The new economic development initiative mentioned in paragraph 76 is also expected to contribute to social inclusion. Geographically, IFC will seek to support regions outside of generally more affluent Western and Southern Provinces.

F. IMPLEMENTING THE COUNTRY PARTNERSHIP STRATEGY

i. Financing Parameters

82. **Sri Lanka became an IDA-IBRD blend country as of FY12, eligible for IDA16 resources and IBRD lending.** This marks Sri Lanka's re-access to IBRD resources for the first time since blend status was lost in 1986. An indicative lending program for IDA and IBRD combined for the first two years of the CPS is US\$500 million in FY13 and US\$527 in FY14. Sri Lanka's eligibility for IDA will likely end at the end of the IDA16 cycle.

The Government is interested in IBRD lending of up to US\$500 million annually during FY15 and FY16, which would, however, depend on the macroeconomic environment in Sri Lanka, overall demand for IBRD resources from other clients, IBRD financial capacity and global economic developments. It is foreseen that IBRD financing will be used primarily for investment projects supporting regional economic development, urban infrastructure, encouraging innovation and technology adoption, and improving the skills of the labor force. Lending plans will be reviewed at the time of the CPS Progress Report.



Fruitful agricultural operations carried out throughout Sri Lanka



Preserving the abundance of country's natural

83. **Assuming growth prospects remain strong and macroeconomic balances and overall creditworthiness continue to improve, it is expected that IDA resources will be phased out during the CPS period through a managed transition to IBRD-only status.** The indicative country envelope for IDA16, covering FY12-14, is SDR 458.1 million (about US\$ 688 million).⁴⁶ This represents an increase of about 30 percent over its IDA 15 replenishment as well as improvements in Sri Lanka's country performance.⁴⁷ In FY12, the first year of IDA16 which preceded the CPS period, the IDA allocation amounted to SDR 162 million (about US\$ 249.8 million).⁴⁸

⁴⁶ IDA envelope beyond the first year of the IDA16 period is indicative and could change depending on: (i) total IDA resources available, (ii) the country's performance rating, (iii) the number of IDA eligible countries, and (iv) the performance and assistance terms of other IDA-eligible countries. Also, IDA allocations are provided in SDRs, and the US dollar equivalent amount for IDA 16 is based on replenishment rate of 1SDR=US\$1.50233, but the exchange rate for each IDA operation depends on the applicable prevailing rate at the time of approval. Furthermore, about 97 percent of the IDA resource is available as IDA credits on blend terms, while the remaining 3 percent is available on hard terms that can only be accessed by blend countries but has lower concessionality.

⁴⁷ IDA resources are allocated through a performance based allocation system that provides higher allocations to countries with better performances in delivering results at the same income level, other things equal.

⁴⁸ The actual commitment of IDA resources in FY12 was US\$ 111, with the expectation that the unused FY12 allocation would be committed in FY13.

The same year saw the introduction of IBRD financing for the Metro Colombo Urban Development Project. Given that Sri Lanka has obtained access to IBRD resources, and its per capita income has exceeded the IDA income cutoff for more than three consecutive years,⁴⁹ the country is expected to graduate from IDA through a managed transition as IBRD resources are phased in.

During the transition to the IBRD-only status, IDA resources would continue to play an important role to support governance reforms and to address the critical needs in the social sectors. In addition, the World Bank could work with the authorities to explore the additional flexibility for more front/back-loading of IDA resources across the years in FY12-14 to help ensure a stable level of overall financing. Box 1, below, summarizes the ongoing and proposed IDA and IBRD portfolio.

⁴⁹ The GNI per capita of Sri Lanka has exceeded the IDA operational income cutoff since 2004 but the country did not become credit-worthy for IBRD lending until 2011. In FY12, the corresponding IDA cutoff is a 2010 GNI per capita of US\$ 1,175 while the figure for Sri Lanka is US\$ 2,290.

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Summary of Ongoing and Proposed IDA and IBRD Portfolio

Ongoing

Dam Safety and Water Resources Planning (FY08)
 Public Sector Capacity Building (FY08)
 Sustainable Tourism Development (FY10)
 Higher Education for the Twenty First Century (FY10)
 Provincial Roads (FY10)
 North East Local Services Improvement (FY10)
 Second Community Development and Livelihood Improvement (Gemi Diriya) (FY10)
 Small and Medium Enterprise Development Facility (FY11)
 Road Sector Assistance (FY11)
 Metro Colombo Urban Development (FY12)
 Transforming the School Education System as a Foundation of a Knowledge Hub (FY12)
 E-Sri Lanka (FY12)
 Emergency Northern Recovery (FY10)
 Community Livelihoods in Conflict Affected Areas (Reawakening) (FY11)

Indicative FY13 and FY14 lending

Second Health Sector Development (FY13, \$200 million IDA)
 Skills Development (FY14, \$100 million IBRD)
 Regional Growth Pole/Economic Development (FY13, \$50 million IDA and \$250 million IBRD)
 Urban Infrastructure/Transport (FY14, \$227 million IDA, \$100 million IBRD)
 Investment Policy Reform (FY14, \$100 million IDA)

Tentative FY15 and FY16 lending

Private Innovation and Technology Adoption (FY15)
 Legal and Judicial Reform (FY15)
 Solid Waste Management (FY16)
 Early Childhood Education (FY16)
 Water and Sanitation (FY15)

Note: FY13 and FY14 total IDA lending is expected to be \$577 million. FY13 and FY14 total IBRD lending is expected to be \$450 million.

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ii. Instruments

84. **In order to address the shift in focus toward support for the evolving middle income country agenda, the range of instruments will expand.** As there is increasing demand from Government for information on how other countries have addressed the transition to middle income country status, the demand for AAA has increased. Also, with an increasing need for policy actions (in addition to investments in hardware), the demand for policy lending has increased as well. And, as institutional capacity to focus on results increases, the demand for results-linked disbursements has increased.

It is therefore anticipated that a wider range of instruments will be used,⁵⁰ including Development Policy Loans and Program-for-Results financing, with the appropriate instrument for each specific project to be determined during project preparation.

85. **The new CPS aims to better coordinate and integrate Trust Funds in the portfolio, in line with the World Bank's policy to modernize Trust Funds through operational simplification and strategic alignment.** This would include: (a) aligning Trust Fund management to the way the World Bank products are defined, managed and reported; (b) using the same control and quality assurance framework for trust funds that are used for IBRD and IDA resources; (c) using a strengthened approach to better define the results and risk management of Trust Funds.

More specifically, going forward we aim to not only include Trust Funds in the CPS, but also to: (a) integrate Trust Funds into the results framework of the CPS by tracking results in the CPS from all funding sources; (b) include Trust Funds in the portfolio reviews in order to examine alignment with the CPS; (c) track similar portfolio indicators for Trust Funds, such as riskiness, disbursements and performance. New Trust Fund tasks will be carefully selected to focus only on key strategic goals and not to overload the Government and the task teams.

50 A delegation from the Government of Sri Lanka visited the World Bank Group in Washington in July 2011 and met with the World Bank Treasury Department, the Multilateral Investment Guarantee Agency and representatives of other parts of the World Bank Group. In addition, staff of the Treasury Department of the World Bank conducted a workshop in Colombo to familiarize Government counterparts with IBRD.

world bank group partnership strategy Contd...

86. **IFC intends to continue to actively provide both investment and advisory services.** Over the coming CPS period, IFC will design programmatic solutions instead of individual products and one-off projects.

iii. **Monitoring and Evaluation**

87. **Monitoring and evaluation will be especially important given the CPS's flexibility and the shift in focus toward the middle income country agenda.** Strategic reviews will be held annually to monitor CPS implementation and ensure continued alignment of the CPS with the evolving country needs. A CASPR will be prepared in FY14 at which time any necessary revisions including the results matrix will be discussed.

88. **Pilot use of third party monitoring will be evaluated and scaled up if found useful.** Currently, third party monitoring is being conducted for the Road Sector Assistance Project⁵¹ to involve users and stakeholders in the monitoring process and to strengthen the capacity of the Road Development Authority to make benefit monitoring an integral part of road sector. Over the coming CPS period, the World Bank hopes to expand the existing pilot to other projects. As part of the planned engagement with youth, it is hoped that the youth networks will take an active role in monitoring the impact of the CPS as a whole with particular emphasis on activities that are of direct relevance to youth.

51 The ongoing pilot is being conducted with support from the Demand for Good Governance window of the Social Development Civil Society Trust Fund.

world bank group partnership strategy Contd...

iv. **Complementarities with Activities of Other Development Partners**

89. **The development partner landscape in Sri Lanka continues to evolve.** While the World Bank has traditionally been one of the ‘big three’ development partners in Sri Lanka, together with Japan and the Asian Development Bank, China and India have emerged as the largest contributors, primarily through export credits.

With Sri Lanka’s transition to MIC status, the Government has broadened its options for foreign financing for public investment, through a blend of concessional and non-concessional external assistance. Capital market financing is also increasingly being tapped with issuance of long-term sovereign bonds. Sri Lanka continues to benefit from a number of grants from multilateral and bilateral development partners.

90. **In line with the Paris Declaration on Aid Effectiveness, both development partners and the Government have strengthened efforts to coordinate and harmonize foreign assistance.** Among the mechanisms in place in this regard are: (a) the Development Partners Forum; (b) the Development Partners Committee supported by a Secretariat and sector-based working groups.

91. **Development Partners Forum.** The Development Partners Forum is a broad information-sharing and coordination mechanism, in which Development Partners share respective assistance strategies, programs and new initiatives. The World Bank is one of the six foreign aid missions that form the Development Partner Committee, mandated by the larger Development Partners Forum to manage the interaction with the Government on behalf of the development partners. The Development Partner Committee comprises of three multilateral - World Bank, UN Resident Coordinator, Asian Development Bank, and three bilateral missions selected on an annual basis by the Bilateral Donor Group.⁵² The Chair of the Development Partners Forum also chairs the Development Partners Committee.

52 For 2012, the three bilateral Development Partners on the Committee are AusAID, Japan International Cooperation Agency and USAID.

world bank group partnership strategy Contd...

92. **During the CPS period the World Bank Group will continue to be an active member of the development partner community, coordinating with relevant working groups and reaching out to new development partners.** IFC is a member of the Development Partner Forum Private Sector Development working group, chaired by USAID.

The CPS is designed to be flexible and to focus on the middle income country agenda



risk
and risk management

risk and risk management

93. **This CPS includes a careful assessment of key risks in the program, and steps to manage such risk.** The World Bank Group program in Sri Lanka faces two types of risks in implementation of the Country Partnership Strategy. The first set of risks is related to the implementation environment and is reflective of Sri Lanka's specific development challenges. The second set of risks is related to the design of the program itself.

A. RISKS RELATED TO THE IMPLEMENTATION ENVIRONMENT

94. **External shocks could impact the macroeconomic framework.** The main external risk is that key trading partners, lenders and financiers would be unable to sustain expected levels of engagement. Sri Lanka is vulnerable to Euro area debt problems and weakening growth in several large emerging economies.

Sri Lanka relies heavily on European demand for its merchandise exports as well as service exports.⁵³ A deepening of the Euro Area crisis would lead to weaker exports and capital flows.⁵⁴ Sri Lanka is also vulnerable to disruption in imports of petroleum products, most of which come from Iran. The risk of reduced demand for exports can be mitigated by increased focus of trade with growing economies of East and South Asia.

95. **There are also macroeconomic risks originating from within Sri Lanka.** Increased international competitiveness leading to a reduced trade deficit is essential for macroeconomic stability. Without an increase in exports, remittances or FDI, Sri Lanka will be unable to finance the investment and intermediate imports required for growth.

53 Thirty five percent of goods exports go to Europe and 37 percent of tourist arrivals come from Europe.

54 Since mid-2009 significant investment flows from Europe has found its way into assets in the country particularly through successive GoSL Eurobond issues, investments into the Colombo Bourse and investments into GoSL treasury bills and treasury bonds. The recent Global Economic Prospects report estimates exposure to Sri Lankan assets by European banks at close to 10 percent of country's GDP or US\$ 5.5 billion. This presents a significant vulnerability in face of a sudden withdrawal of investments as the exposure amounts to near entirety of country's gross official reserves as of end 2011. However, such risks are mitigated by the fact the much of these investments are medium to long term in nature. The spreads on Sri Lanka Eurobonds in secondary markets trading has been rising since end 2011. The current spreads of 461 basis points is the highest in 20 months.



Healthy living with healthy growing



A new weave to develop the SME's

To that end, an exchange rate that is both market-driven and reasonably stable will be essential. To the extent the exchange rate volatility witnessed in February and March 2012 (when the Central Bank curtailed its intervention) reflects a short-lived process of finding equilibrium following the Central Bank's reduced intervention, it is a positive sign, though one that requires close monitoring.

96. **Expenditure pressures may slow down the progress on reducing the fiscal deficit.** Continued efforts will also be required to ensure progress in reducing the fiscal deficit and debt. Strong effort on tax administration can mitigate the risk of slower than anticipated progress on fiscal deficits. Analysis of State Owned Enterprises (including that being performed by the World Bank) will help identify the extent of risk associated with contingent liabilities.

Although Sri Lanka's cost of borrowing has declined thanks to improvements in the sovereign credit ratings, costs could increase if there are problems in the international financial markets or if Sri Lanka's credit ratings are not maintained. Investment and productivity increases are essential for the achievement of sustained growth. Both rely heavily on further improvements in the investment climate and predictability of the policy environment. Lapses on either issue would result in lower than expected growth. Inflation is expected to remain low over the CPS period. This scenario is subject to risk, however, if the economy were to overheat.

Finally, rapid credit growth achieved in the past year could be a foreshadowing of an increase in non-performing loans and potentially serious issues in the financial sector, ultimately raising the risks of high contingent fiscal liabilities.

The Government is a significant stakeholder in a number of private commercial banks. There is a risk that the Government's ownership and position on the Board of Directors may influence the decisions of the banks' management for non-commercial purposes.

97. **Macroeconomic risks will be monitored throughout the CPS period.** The World Bank produces monthly and semi-annual macroeconomic monitoring notes, and has initiated an analysis of potential impacts of a Eurozone crisis. In addition, the CPS program includes a growth analysis report, a fiscal issues note, a Public Expenditure Review/ PEFA, analysis of the judicial system, as well as dialogue on public financial management and investment climate reforms. All of these activities will be shared with Government in an effort to agree on a set of measures to mitigate the associated macroeconomic risks.

risk and risk management Contd...

98. **Continued efforts will also be required to ensure social inclusiveness and political openness as well as economic integration of conflict affected areas and to make sure that the benefits of growth are widely and equitably shared.** A process for implementation of recommendations of the Lessons Learned and Reconciliation Commission will be important. The World Bank Group is providing support including ongoing projects to help internally displaced persons resettle and reestablish livelihoods. Analytical work on inclusive growth, labor and poverty will also support dialogue and actions in these areas.

99. **Sri Lanka is vulnerable to natural disasters and extreme weather events, including floods, droughts, and cyclones.** In addition to the immediate impact of destroyed assets, natural disasters and extreme weather events can affect economic growth by diverting the development funds for emergency response, relief and recovery efforts and by affecting the income generating activities of the population. The CPS program includes a trust funded activity, “Strengthening the Disaster Management System and Mainstreaming Climate Change Mitigation in Urban Development”, which supports the Government of Sri Lanka’s efforts to address these risks.

B. RISKS RELATED TO THE PROGRAM

100. **The World Bank’s portfolio faces risks related to governance, procurement and financial management.** Recent assessments on these topics concluded that Sri Lanka has made efforts toward reforming and developing its systems, while suggesting areas for further modernization. Portfolio related governance risks will be addressed through project and sector specific mitigation measures, including through Governance, Accountability and Anti-Corruption Action Plans (GAAP).

The proposed AAA to improve SOEs management and effectiveness, the DPL to improve the overall investment climate, as well as the proposed Judicial Reform Project to support legal and regulatory reforms will also contribute to enhancing the dialogue on governance related issues. Fiduciary risks will be mitigated by continued support to the Auditor General Department for enhancing the scope and coverage of public audits as well as to strengthen value added audit services, and support to the Institute of Chartered Accountants of Sri Lanka for enabling the adoption of IFRS to State Owned Enterprises and small and medium enterprises, as well as for improving the quality of audit practices.



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In addition, the World Bank expects to build on support provided during the FY09-12 CAS to the Parliamentary committees for budget oversight to strengthen their oversight functions. In addition, fiduciary assessments will be performed at a sector level in advance of any proposed Program-For-Results operation.

101. **Program implementation also faces risks related to Government capacity to manage the increased volume of lending.** Although Government agencies have skilled professional staff, the massive public investment program will put strains on staff. The risk that capacity within Government will be insufficient, given the increased level of engagement in addition to the Government's existing investment program, is mitigated by the World Bank minimizing transaction costs by moving toward use of country systems for financial management, and proactively restructuring projects.

A related risk is that Government priorities may change over the course of the CPS period. This risk will be minimized by taking a flexible approach, with the CPS used to set the broad direction for engagement in line with the Government's own strategy and to identify the program for the first two and a half years. The CPS Progress Report will provide opportunities to realign and modify the program accordingly.

102. **In addition to the risks above, there are two sets of key risks faced by IFC.** The first is a program risk due primarily to IFC's catalytic role that appropriate partners may not be found for the planned initiatives. This risk should be mitigated by lessons learned from IFC's past experience in Sri Lanka and its growing network of partners. The second is the risk from the expected increased weighting to the financial sector in IFC's investment portfolio, which will be above 50 percent for much of the CPS period.

Sri Lanka has a relatively sound banking system overall, and the exposure is therefore not an immediate concern. However, IFC will actively seek to build a diversified portfolio, will diversify within the financial sector across different types of financial institutions, and, through advisory services, will strengthen its portfolio financial institutions, where necessary.



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