

A CHANGED CONTEXT

This Country Assistance Strategy (CAS) is being presented to the Board at a challenging time for Sri Lanka, in circumstances that are significantly different from those in 2003 when the last CAS was presented. Echoing the broad-based sense of optimism at that time, the previous CAS was aligned to support the goals of peace, economic growth and equity.

In terms of peace, developments during the last five years have been sobering. After a temporary slowdown in armed confrontation following the 2002 ceasefire agreement (CFA), violence reemerged in 2005, resulting in renewed and major human suffering. The Rajapakse Government has made it clear that while it is pursuing military operations to eradicate terrorism, it is also fully committed to finding a political solution to address the legitimate grievances of Sri Lanka's minority communities. Although local government elections for the East were held in the spring of 2008, the political process towards increased devolution and local self-determination, spearheaded by the All Party Representative Committee, still has a considerable way to go.

Despite the escalating conflict, economic growth has been strong since 2003-averaging 6.3 percent per annum. But macroeconomic imbalances, particularly high inflation and persistent budget deficits, are emerging as serious concerns.

Despite aggregate economic growth, increasing inequality held back poverty reduction during the 1990s. While the latest Household Survey indicates that the last decade's seemingly unstoppable increase in inequality is finally abating, at least in the non-conflict areas, the challenge of accelerating and sustaining growth outside the Western Province remains.

Besides the three goals of peace, growth, and equity, the previous CAS also had to respond rapidly to the devastating tsunami that hit Sri Lanka in late 2004.


In light of this complex and challenging environment, the new CAS adopts a more focused approach to the areas of engagement and a more flexible approach to the nature of the Bank's engagement in Sri Lanka. The design of the CAS has been informed by extensive consultations not only



with the Government but also with a broad cross-section of Sri Lankan society across many parts of the country. The consultations and the experiences from implementing the previous CAS have shaped the Bank's thinking, both about what the Bank should be focusing on in terms of its assistance and how best to deliver that assistance.

THE 'WHAT' OF BANK ASSISTANCE

The Bank will support the overall objectives of the



Hearing and speech impaired P.Dharmadasa grows varieties of exotic anthurium flowers for a living with support from the **Gemi Diriya Project**

Government's vision for economic development laid out in the '*Mahinda Chintana*-10-year Development Framework'.

The *Mahinda Chintana* aims at accelerating growth, with particular emphasis on the achievement of equitable development, recognizing that there has been a “perpetuation of income disparities, both among income earners and geographic regions”. The *Mahinda Chintana* focuses on three main areas: (i) achieving more equitable development through accelerated rural development; (ii) accelerating growth through increased investment in infrastructure; and (iii) strengthening public service delivery. These objectives were validated during the CAS consultations and serve as our overarching objectives.

In order to maximize impact and mitigate risks, the Bank has designed a cautious program of interventions that can deliver positive development outcomes in poor and underserved areas, even in Sri Lanka's changed circumstances.

The proposed lending program is based on a series of narrowly-scoped investment projects. The program strongly emphasizes community-focused projects and projects delivered through local and provincial governments. These projects aim to provide infrastructure, public services and livelihoods at the local level. In line with the Government's priorities and the inputs the Bank received during its public consultations for this CAS, particular emphasis will be laid on improving connectivity and market access through rehabilitation and enhancement of the road network. The program will also prioritize assistance for reconstruction and service delivery in conflict-affected areas, including support for nascent local government institutions in the East.

The Bank will systematically seek to build domestic constituencies for policy reform and facilitate the sharing of international best practices. The Bank's

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experience from the last CAS shows that while it may not always be feasible to pursue grand reforms, it is nonetheless productive to pursue incremental improvements whenever possible. The Bank must be agile in exploiting openings for policy reforms if and when they appear, and carry out continuous consultations to build constituencies for policy and institutional changes. This was echoed during the CAS consultations which revealed a strong demand for the Bank to more systematically engage diverse audiences, including through partnerships with local think-tanks and civil society organizations, to more proactively facilitate the sharing of international best practices and expertise with Sri Lankan audiences, and to nurture public policy discussions.

The IFC will further strengthen its rapidly scaled up engagement in Sri Lanka. On the investment side, IFC provides additionality by offering longer-term capital than is otherwise available in the Sri Lankan market. The IFC will increasingly reach out to second-tier, smaller clients and help develop the domestic financial market. On the advisory side, the IFC will continue to provide services through the South-East Asia Enterprise Development Facility, a five-year, multi-donor trust

fund established especially for this purpose. The IFC and the Bank will further enhance collaboration to leverage their joint impact, as successfully done, for example, with the ongoing Bank Group support for rural electrification.

THE 'HOW' OF BANK ASSISTANCE

The Bank's experience from the last CAS shows that it has the ability to implement projects even under highly adverse conditions. There is no denying that maintaining the quality of the Bank portfolio in Sri Lanka's volatile operating environment is a challenge. Several projects have faced implementation difficulties on account of the escalating conflict. But through robust project design and strong field-based supervision, the Bank has demonstrated its ability to deliver relevant development outcomes on the ground and rapidly adapt to changing circumstances when it must—as evidenced, for example, by the change in focus from infrastructure to livelihoods in community driven development in conflict-affected areas. The Bank will aim high in project implementation with the support of its broad network among civil society organizations.

As the conflict looms large over Sri Lanka, it is critical that the Bank's engagement be highly conflict-sensitive. Our work in Sri Lanka needs to minimize the risk of Bank activities inadvertently fueling ethnic tensions and further straining Sri Lanka's social fabric. Furthermore, we need to manage the reputational risk of being perceived as a partial or biased actor on the development scene. At the program level, the Bank will not allow resources committed for the North and East to be reprogrammed to other parts of the country, even if a deteriorating

Geethika (7) clutches close to her the North East Housing Reconstruction Project beneficiary accounts book. With her are siblings Abhinaya (2) and Kiruplani (9) in their nearly finished house in the village of Vallathapitiya, in Ampara. 22,444 houses were rebuilt by June 2008 out of the targeted caseload of 34,784 houses under this project.



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situation on the ground renders it impossible to implement activities in the North and East. At the project level, greater conflict-sensitivity in design, implementation, and monitoring and evaluation will be achieved by subjecting all lending operations to a 'conflict filter'. The conflict filter will require projects to show that benefits are transparently distributed and potential tensions are mitigated through broad-based consultations and credible redress mechanisms.

The Bank will systematically seek opportunities to address the causes and consequences of the conflict. The North and East of the country have been most severely affected by the last 25 years of fighting and displacements. Against this background, the Bank will emphasize efforts to improve access to public services and enhance livelihood opportunities in conflict-affected areas, with a particular focus on rehabilitation of roads, irrigation networks and water supply. The Bank would also provide assistance to address traumatized people's needs in the conflict-affected areas. In addition, the Bank will seek to enhance inter-ethnic awareness by helping to expand the social space for people belonging to different communities. This would be done, for example, in education programs, by supporting English as a link language, working towards mixed Tamil-Sinhalese schooling and teachers' education, and encouraging members of different ethnic groups to work together around common goals in community driven development initiatives.

MANAGING RISKS

The CAS responds to the country's current needs and emerging opportunities while taking into consideration ongoing uncertainties and risks. Despite careful selection and design, the proposed program remains

vulnerable to further deterioration because of the conflict and requires careful implementation and adaptation. Deepening the Bank's existing networks of civil society organizations and development partners will help the Bank to monitor and assess these risks. The enhanced emphasis on conflict sensitivity will help mitigate the Bank's reputational risks. Managing the significant macroeconomic risks arising from persistently high fiscal deficits, high inflation and Sri Lanka's vulnerability to external shocks, requires strong corrective measures by the Government—a point emphasized in our ongoing policy dialogue. Finally, the Bank faces considerable fiduciary risks, in particular in the North and East, where the situation is especially volatile and where intensive supervision is most challenging.

At the same time, we believe that there are substantial benefits to the Bank's engagement in Sri Lanka, both in assisting the Government in fulfilling its long-term vision of accelerating growth and reducing poverty, and in proactively addressing the causes and consequences of the conflict. These would be lost if the Bank were to disengage. In this sense, there are also significant development and reputational risks to the Bank from not remaining substantially engaged in Sri Lanka. This CAS strikes a balance between the development and reputational risks of remaining engaged as Sri Lanka's long-standing development partner in this fluid and complex situation, against the development and reputational risks of disengagement.

ISSUES FOR THE EXECUTIVE DIRECTORS

1) Is the proposed Country Assistance Strategy—including its conflict-sensitive approach—likely to be robust and flexible enough to mitigate the development and reputational risks of the Bank's engagement in Sri Lanka?

2) Is the proposed program of activities and choice of instruments appropriate, considering the country circumstances and the Bank's comparative advantages?