Public Disclosure Authorized

Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 02-Dec-2022| Report No: PIDC35319

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Sri Lanka	P179808	Sri Lanka Stability and Resilience Development Policy Operation (P179808)	
Region	**Estimated Board Date**	**Practice Area (Lead)**	**Financing Instrument**
SOUTH ASIA	May 31, 2023	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	**Implementing Agency**		
DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA	Ministry of Finance, Economic Stabilization and National Policies		

Proposed Development Objective(s)

To support foundational reforms that strengthen macroeconomic stability and sustainability, mitigate the impact of current and future shocks on the poor and vulnerable, and drive an inclusive and private-sector-led recovery and growth path.

Financing (in US$, Millions)

SUMMARY

Total Financing	300.00

DETAILS

Total World Bank Group Financing	300.00
World Bank Lending	300.00

Decision
The review did authorize the preparation to continue

B. Introduction and Context

Country Context

Sri Lanka is facing unprecedented macroeconomic challenges, due to unsustainable debt and a balance of payments crisis. Usable reserves are sufficient to cover only about a week of imports, resulting in shortages of essential household items and economic inputs. Amid depleted reserves, Sri Lanka announced an external debt service suspension in April 2022 and the economy contracted by 4.8 percent in the first half of 2022. Inflation, driven by monetization of fiscal deficits, currency depreciation, and high global oil prices, reached 66 percent (y-o-y) in October. Remittances declined sharply, leading to a widening of the current account deficit. In the financial sector, banks' solvency and liquidity is under pressure due to their sizable exposure to the distressed sovereign, including state-owned enterprises (SOEs), and weakening asset quality. Poverty is estimated to have more than doubled between 2019 and 2022.

Going forward, the economy is projected to contract by 9.2 and 4.2 percent in 2022 and 2023, respectively, due to foreign exchange liquidity shortages, job and income losses, and supply-side constraints. Restructuring of both external and domestic debt is critical to restore debt sustainability. Despite reduced primary deficits and a benign current account deficit, multilateral and bilateral support and increased capital inflows are needed to close the financing gap. A prolonged delay in the approval of an IMF program and in subsequent external financing support from international partners could lead to a sharper economic contraction in 2023. Beyond 2023, the scarring effect of the crisis, depletion in human capital, and tight external financing is expected to lead to a fragile recovery.

While poor policy choices, and weak and opaque governance led to the current crisis, the government has recently announced several structural reforms needed to regain a sustainable and resilient growth path. These include reforming SOEs, improving fiscal oversight and debt management, and enhancing competitiveness through integration into global value chains. These reforms are included in the government program as laid out in the 2022 interim Budget and the 2023 Budget.

Relationship to CPF

The preparation of the DPO is closely aligned with the ongoing preparation of a new 3-year CPF, which focuses on enhancing macro-fiscal recovery, improving resilience and protecting human capital.

C. Proposed Development Objective(s)

To support foundational reforms that strengthen macroeconomic stability and sustainability, mitigate the impact of current and future shocks on the poor and vulnerable, and drive an inclusive and private-sector-led recovery and growth path.

Key Results

The proposed operation seeks to address the structural causes of the current crisis, regain a sustainable growth path, and help the poor and vulnerable cope with the crisis. The expected key results include better economic governance (greater fiscal and debt oversight, reduction of the sovereign-financial sector nexus, improved energy sector performance and transparency), a reduction in market distortions (reduced role of SOEs in the economy, simplified and lower import duty levels, broadband infrastructure sharing) to enhance the role of the private sector, and improved governance, efficiency, and effectiveness of the social protection system. Progress in this direction will be measured using nine indicators that correspond to the reform objectives of the operation.

D. Concept Description

The first pillar of the operation, *Transforming Economic Governance*, includes measures to strengthen the governance framework, institutional structures, and coordination in four key macro-critical areas. First, the establishment of an independent, non-partisan Parliamentary Budget Support Office and the consolidation of a single Public Debt Management Law will improve fiscal oversight and debt management. Second, tax administration policy reforms, including better information sharing and mandatory e-filing, will improve coordination across financial institutions, boost revenues from high net-worth taxpayers, and support the use of risk-based audits in later years. Third, institutional weaknesses in the financial sector, which have undermined sector stability, will be addressed by strengthening the existing regulation on single obligor limits and the establishment of a financial sector crisis management committee. This is to be followed by support on restructuring of state-owned banks and the modernization of the insolvency framework. Fourth, power sector restructuring will be initiated through the Electricity Reform Bill, followed by functional and financial separation of the Ceylon Electricity Board into several companies to improve energy sector performance, as well as by complementary measures that enhance energy efficiency.

The second pillar of the operation, *Enhancing Growth and Competitiveness*, includes reforms that are essential for Sri Lanka's medium to long-term competitiveness and growth performance. This will initiate the reform of the SOE sector, a major source of fiscal risks, by creating the institutional structure for a SOE Holding Company, and subsequent implementation of SOE restructuring and divestment. Trade and investment policy uncertainty will be reduced through the phase-out of para-tariffs in a revenue neutral way and the consolidation of investment legislation, including on foreign direct investment. Private sector participation and investment in the broadband sector will be revitalized through the issuance of an open access and infrastructure sharing policy, followed by a forward-looking spectrum allocation policy.

The third pillar of the operation, *Protecting the Poor and Vulnerable*, seeks to improve the governance, effectiveness, and efficiency of the country's social protection system. Under this pillar, the reform measures will support the regulations, financing, and implementation of a new welfare benefit payment scheme, followed by provisions for a more widespread use of the social registry and recertification of beneficiaries in later years.

E. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

Policy actions (PAs) under this operation are expected to have positive impacts on the poor and vulnerable. Most of the PAs and triggers are expected to have positive or neutral welfare impacts. A comprehensive assessment of all relevant reform areas under the DPO series is ongoing and will provide a baseline for simulating alternate reform options, identifying any adverse impacts, and proposing mitigation mechanisms. Special attention will be paid to the reforms on SOEs, to cushion adverse welfare impacts of potential layoffs, and to the reforms on para-tariffs, to ensure overall progressivity of fiscal tax and transfer instruments.

Environmental, Forests, and Other Natural Resource Aspects

Policy actions under this operation are not expected to have significant direct negative impacts on Sri Lanka's environment, forests, and natural resources. The DPO will help enhance fiscal resilience and sustainability, and hence address fiscal constraints for disaster relief and risk reduction. Furthermore, the energy reforms are likely to provide significant environmental benefits through a more efficient power sector and enhanced energy efficiency measures.

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APPROVAL

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