



**ASIAN INFRASTRUCTURE
INVESTMENT BANK**

L0081A

L0124A

July 21, 2022

**Project Change Document
of the Asian Infrastructure Investment Bank**

The Democratic Socialist Republic of Sri Lanka

- 1. Support to Colombo Urban Regeneration Project**
- 2. Reduction of Landslide Vulnerability by Mitigation Measures Project**

This document has a restricted distribution and may be used by recipients only in performance of their official duties. Its contents may not otherwise be disclosed without AIIB authorization.

Content

1.	Background	3
2.	The Projects Under Implementation in Sri Lanka.....	4
3.	COVID-19 and Economic Crisis.....	6
4.	Proposed Changes.....	8
5.	Approval Sought	14
	Annex 1 Economic Outlook of Sri Lanka	15

1. Background

1. Sri Lanka is faced with an unprecedented crisis. As per the IMF Article IV Consultation Paper, dated March 2022, Sri Lanka has been severely hit by Covid-19. Real Gross Domestic Product (GDP) contracted by 3.6% in 2020, due to a loss of tourism receipts and necessary lockdown measures. This was on back of diminishing external buffers exacerbated by Easter Sunday terrorist attacks in 2019 and major policy changes including tax cuts. Tourism sector, which accounted for 5% of GDP in 2018, ground to a complete halt. Apparel and textile sector that accounted for almost 50% of export revenues in 2019 and employed nearly a million workers was also one of the worst affected sectors by the pandemic. In the preceding years, Sri Lanka had recorded a healthy growth rate of around 6.5% between 2010 and 2015.

2. The GoSL took a number of relief measures to cope with the impact of the pandemic, including macroeconomic policy stimulus, increase in social safety net spending and loan re-payment moratoria for affected business. There was a strong vaccination drive also put in place. AIIB had extended Covid facility to Government of Sri Lanka (GoSL) through sovereign backed lending to two state owned banks, which was approved on February 25, 2021. The aim of the facility was to address the urgent need for liquidity to provide credit to corporate and small and mid-sized private enterprises (SME). The amount was fully disbursed in the 3rd quarter of 2021. However, large foreign exchange debt service payments and a wider current account deficit in the face of the pegged exchange rate have resulted in significant foreign exchange shortages in the economy.

3. Further adverse developments in the first quarter of 2022 significantly worsened the macro situation. Economies in all stages of development are facing commodity price increases, broadening price pressures and high inflation. This resulted in the GoSL announcing suspension of servicing of external debt on 12 April 2022, the first time since its independence in 1948. The suspension will continue pending and orderly restructuring of those obligations in a manner consistent with an economic adjustment program expected to be supported by the International Monetary Fund (IMF), which is currently being discussed. The announcement by GoSL also mentioned that the preferred creditor status of Multilateral Banks will be honored. AIIB has an exposure of USD 460 mn out of which USD 219.2 mn has been disbursed. Further, these loans have been classified as Stage2 for the Expected Credit Loss (ECL) on life-cycle basis following the rating downgrade of Sri Lanka in 2021.

4. In May 2022, the GoSL requested AIIB to repurpose its two existing loans that had significant undrawn amounts, for emergency purchase of medicines and medical equipment. The repurposing has the following advantages:

- Since the investment projects will be slow moving due to the current macroeconomic situation and lack of counterpart funding, the approved amount of the projects can be effectively utilized for the urgent medical needs of Sri Lanka, and the disbursement can be accelerated.
- The commitment fees on the undrawn amount of these two projects will be reduced.

5. This Project Change Document seeks approval of the proposed project change to the two projects in Sri Lanka and associated amendments to the project's legal documents. The two projects are: (i) the Support to Colombo Urban Regeneration Project (SCURP); and (ii) the Reduction of Landslide Vulnerability by Mitigation Measures Project (RLVMMP). The following changes are proposed: (i) creation of a new emergency component in each project to finance urgent expenditure needs of the health sector, including critical medicines and other medical supplies; (ii) reallocation of 70 million and 30 million from the original components of SCURP and RLVMMP, respectively, to the emergency component; and (iii) an update of the results framework.

2. The Projects Under Implementation in Sri Lanka

Support to Colombo Urban Regeneration Project

6. On April 4, 2019, the AIIB Board approved a loan of USD200 million for the Support to Colombo Urban Regeneration Project (SCURP). The Bank and the Government of Sri Lanka (GoSL) signed the Loan Agreement on April 25, 2019. Consequently, the Loan Agreement became effective on July 22, 2019. The Project Objective is *"to improve housing conditions of low-income communities and increase land use efficiency in Colombo through investments in the construction of affordable housing and redevelopment of land, with associated policy and system enhancements"*. The loan closing date is December 31, 2025. The Environmental & Social category of this project is Category A. The three original project components are:

- Component 1: Housing Construction. Supports the construction of about 5,500 affordable housing units for underserved communities in multi-story apartment buildings.
- Component 2: Land Redevelopment. Maximizes the revenue from the land that will become available after the households from the underserved communities move into the new apartment units constructed under the project or other government's program.
- Component 3: Technical Support and Project Management. Supports project management and other measures to improve implementation of the URP.

7. **Project implementation status.** Since the Project approval, the Project has faced various challenges including 2019 Sri Lanka Easter bombings, 2019 presidential election, termination of the initially appointed Project Director, 2020 parliamentary election, and the ongoing COVID-19 pandemic. Those challenges have negatively affected implementation and hence contributed to the low disbursement to date. As of May 6, 2022, disbursements stand at 16.6% (or USD33 million). Detailed implementation status of each component is as follows:

8. Component 1: Component 1 was agreed in the first project launch mission (July 1-5th 2019) to be implemented over three overlapping phases to allow lessons learned from the first phase to be incorporated into the later phases. All contracts for the four sites (Applewatta Phase II, Colombage Mawatha, Obeysekerapura, and Stadiumgama) of the first phase were awarded in 2020 with a total contract value of USD79.36 million. The second phase sites are Furgusion and Madampitiya, and these contracts were awarded in 2021 with a total contract value of USD42.47 million. In total, out of the allocated USD180 million under Component 1, USD122.83 million (AIIB finances 85%) for 4,074 housing units has been committed. Construction of these six buildings is currently underway with different paces.

9. Component 2: The Project is to facilitate redevelopment of identified sites by the private sector or PPP through planning and designing, marketing and, in some cases, providing site improvements and infrastructure. Originally, ten sites were proposed for land redevelopment. A few priority sites initially selected had environmental and social issues, and the Project could not do anything there without addressing them. In 2021, it was agreed to revisit overall approaches for the component and to clarify the criteria in selecting and prioritizing the target sites for this component. Revised TOR for consultancy services to design rules and procedures for this component has yet to be finalized to date.

10. Component 3: Various technical assistance and project management activities have been planned under this component. However, tightened COVID-19 restrictions in 2020 and 2021 and a Cabinet reshuffle in August 2021 negatively impacted on the procurement process for the planned activities. One of the most critical consultancies, a Review of the Urban Regeneration Program (URP) policies, was finally awarded in October 2021. To date, however, the procurement processes of the following consultant services have not been completed: (i) conducting socio-economic surveys and preparation of resettlement action plans; (ii) third-party, independent monitoring of RAP implementation; (iii) community mobilization and livelihood development; (iv) IT service support; and (v) the review and improvement of the national housing policies.

11. In September 2021, the Bank and GoSL discussed the way forward where both parties agreed to defer USD50 million till June 2022 to ensure to get the Project back on track.

Reduction of Landslide Vulnerability by Mitigation Measures Project

12. **Background:** The Asian Infrastructure Investment Bank (AIIB) Board of Directors approved a loan of USD80 million on April 4, 2019 to support the implementation of RLVMM Project (the total Project cost is USD110 million, with USD30 million from the Government of Sri Lanka, GoSL). The project became effective on July 23, 2019, and the loan closing date is December 31, 2023. The Project objective is to *“reduce risk and damage from landslides through the implementation of mitigation measures and enhancement of policy and regulation associated with landslide management”*. The Environmental & Social category of this project is Category B. To achieve that goal, the Project has four components:

- Component 1: Implementation of landslide mitigation measures, including field investigation, detailed designs, construction and supervision/management of civil works implementation to mitigate landslide risk in 147 sites.
- Component 2: Strengthening of policy, standards and institutional capacity related to landslide risk.
- Component 3: Provision of essential facilities and laboratory equipment.
- Component 4: Technical support and project management.

13. **Project implementation status.** The Project has been progressing, but experiencing delays since the beginning, mainly due to four unexpected events: 1) 2019 Sri Lanka Easter bombings, 2) the on-going COVID-19 pandemic, 3) the institutional changes of the line Ministry; and 4) the shortage of construction materials due to the economic crisis. Those challenges have negatively affected implementation and hence contributed to the low disbursement to date. As of May 6, 2022, disbursements stand at 8.4% (or USD6.7 million). Detailed implementation status of each component is as follows:

14. **Component 1: Implementation of landslide mitigation measures:** This component is to design and construct slope reinforcement engineering measures to mitigate the landslide risks for 147 selected landslide prone sites. To date, the design consultant completed the engineering designs of all sites. Six civil works contracts (about USD 12.2 million) covering 24 sites have been awarded, five of which are currently under construction and one contract has been completed. And one additional package (about USD 12 million) covering 32 sites is at the final awarding stage. The implementation of this component is delayed for about 18 months due to the unexpected events mentioned above.

15. **Component 2: Strengthening of Policy, Standards and Institutional Capacity:** Two technical assistance (TA) activities are planned in this component to review and propose the mechanisms for assessment of landslide risks. The TORs of the TAs are ready, but the procurement of these TAs has not started. This component will also cover capacity building activities.

16. **Component 3: Provision of Essential Facilities and Laboratory Equipment:** This component is to procure essential laboratory and field equipment. Five contracts out of nine under this Component have been awarded and implemented.

17. **Component 4: Technical Support and Project Management:** This component is to support project monitoring activities and project management operating costs. These activities are on-going.

3. COVID-19 and Economic Crisis

18. **Background.** Sri Lanka is a lower-middle income country with a per capita GDP of around USD 3,700 and population of around 22 million in 2020. Its economy grew at a healthy rate of 6.5 percent between 2010 and 2015, on average, which was accompanied by a gradual transition from a rural based production economy to a more urbanized economy driven by manufacturing and services.

19. **Pre-pandemic.** Sri Lanka undertook an IMF-supported adjustment program in 2016 to support macroeconomic stability and counter a difficult external environment. While there was some progress in the initial years, several domestic and external shocks in the subsequent years including a drought in 2017, a political crisis in 2018 and a terror attack in 2019 led to significant weakening of the economy. Growth slowed while the public debt surged. Vulnerabilities were further exacerbated by a series of large tax cuts introduced in November 2019. Thus even prior to the COVID-19 pandemic the Sri Lankan economy was facing significant challenges which the pandemic compounded further.

20. **Economic impact of the pandemic.** The pandemic resulted in a sharp economic contraction, of 3.6 percent in 2020. Construction, manufacturing and transportation experienced significant downturn, but the most consequential and lasting impact was from a collapse in tourism revenues, a mainstay of the economy, which all but evaporated overnight. The recession led to sharp jobs and earnings losses in the informal sector as well as some formal sectors. The fiscal deficit widened sharply to 12.8 percent of GDP which resulted in a further sharp increase in public debt, to 110 percent of GDP in 2020. Importantly, however, Sri Lanka lost access to international capital markets, with yields rising to prohibitively high levels. Investors lost confidence in Sri Lanka's creditworthiness in the face of high deficits, high debt, the steep near-term redemption schedule, government's resolve to persevere with tax cuts and expansionary policies, as well as the failure to secure IMF's emergency financing.

21. **Recent Developments.** Though the decisive outcome of the August 2020 elections removed political uncertainty and normalized economic activity, the situation had been deteriorating through 2021. Sri Lanka's GDP remains below pre-pandemic levels. The current account deficit widened significantly in 2021, to an estimated 3.8 percent of GDP, due to high global fuel and commodity prices and growing demand. The fiscal deficit remained very large, at over 11 percent of GDP, due to further deterioration in revenues (as a share of GDP) and despite expenditure restraint. The large fiscal deficit has been financed entirely from domestic sources, including by credit from the central bank thereby increasing the public debt to almost 120 percent of GDP. At the same time, being cut from international capital markets, Sri Lanka has been financing its maturing external obligation directly from reserves. By March 2022, foreign reserves fell to critically low levels—below USD 2 billion, which is below one month of import and around 15 percent of IMF-recommended minimum safe levels. In the first quarter of 2022, the situation had turned into a crisis. The worsened macro situation led to a further spike in energy and commodity prices, delayed the prospects for a recovery in the tourism sector and dented the outlook for external demand. In April 2022, the government felt compelled to prioritize emergency spending over debt service and announced a default on its external obligation.

22. **Outlook.** There is high uncertainty around the outlook for the Sri Lankan economy. GoSL is currently in discussions with the IMF for an adjustment program. Once GoSL has credibly committed to the necessary adjustment, Sri Lanka would need bridge financing to shore it up through the crisis, help sustain imports of essential goods and protect the vulnerable population. As of February 2022, the IMF estimated the fiscal financing gap to be around USD 4.9 billion, or around 5 percent of GDP, per year over the near term.

23. A detailed write-up on the macro-economic situation of Sri Lanka and our assessment of the situation are presented in Annex 1.

4. Proposed Changes

24. The proposed changes are mainly on the following: (i) creation of a new emergency component in both the projects under implementation in Sri Lanka to finance urgent expenditure needs of the health sector, including critical medicines and other medical supplies; (ii) reallocation of 70 million and 30 million from the original components of SCURP and RLVMMMP, respectively, to the emergency component; and (iii) an update of the results framework. Details of these project changes for the two projects are shown in the tables 1-6 below.

25. **The Government's request for project change.** The Government of Sri Lanka sent AIIB a letter dated April 29, 2022 requesting USD100 million on an emergency basis to purchase essential medical supplies, pharmaceuticals, and laboratory reagents. After communication with the AIIB team, GoSL sent AIIB another letter on May 11 requesting AIIB to reallocate USD 100 million undisbursed loans from SCURP and RLVMMMP to support this agenda. A mission to Sri Lanka was conducted in May 2022 to understand the urgent needs of medical supplies from Ministry of Health, and to assess the capacity of the implementing agency. AIIB is also closely coordinating with the key development partners such as the IMF, the World Bank (WB), and the Asian Development Bank (ADB) regarding the emergency support measures for Sri Lanka, to ensure the supports to be provided are adequate and much needed. Currently WB and ADB are also undertaking similar loan repurposing in their portfolios to provide immediate needs and essential items to Sri Lanka.

26. **Rationale for changes.** 1) Sri Lanka is facing a deep and critical economic crisis caused by the combined effects of the prolonged COVID-19 pandemic, higher energy and commodity prices and government's inability to maintain sufficient foreign reserves, among others. The compound economic crisis has led to serious social issues including the lack of essential medicines and other medical supplies, necessitating the government to request AIIB's support on an emergency basis. 2) The proposed project change reallocating USD100 million for an emergency purpose will demonstrate AIIB's commitment and responsiveness to the pressing demands of its members in general, and particularly Sri Lanka in this case. 3) The planned activities under the emergency component are fully aligned with the principle of the extended CRF, and the emergency component is proposed to be processed under CRF. These changes will allow a quick mobilization of AIIB-committed loans to support the urgent needs of Sri Lanka in this critical situation, without further increasing GoSL's debt burden. 4) The emergency component is expected to be implemented quickly, which will help improve the performance of the projects together with the reduced scope of the original project activities. 5) The proposed changes would not change the projects' E&S category to a higher-level.

27. **Details of Project Changes.**

- 1) **Changes on Project Objective (PO).** To respond to adding an emergency component, the POs of these two projects are proposed to be changed as below. The original PO descriptions remain the same, and a sentence representing the sub-PO for the emergency health component is added.
- SCURP: the objective is to improve housing conditions of low-income communities and increase land use efficiency in Colombo through investments in the construction of affordable housing and redevelopment of land, with associated policy and system enhancements, and to enhance the capacity of Sri Lanka to respond to the urgent medical needs.
 - RLVMMP: the objective is to reduce risk and damage from landslides through the implementation of mitigation measures and enhancement of policy and regulation associated with landslide management, and to enhance the capacity of Sri Lanka to respond to the urgent medical needs.
- 2) **Adding a new component – emergency health component** in each project. The newly created emergency health component will support purchasing critical medicines and other medical supplies. The emergency component is allocated with USD 70 million and 30 million from SCURP and RLVMMP (please refer to the project cost change below). These medical items include lifesaving drugs, vaccines, surgical and therapy consumables, medical equipment, and laboratory re-agents. This component could also finance consultancy services and technical assistance to support procurement activities, monitoring and evaluation, and project management. It is proposed this emergency component will be processed under CRF to allow the allocated loans to support the urgent health needs, which are outside the AIB's corporate strategy and thematic priorities under regular operation.
- 3) **Changes on Project Cost.** The Table 1 to Table 4 below illustrate the changes of project cost and disbursement table of these two projects, due to the new emergency component.

Table 1: Proposed Changes to Project Cost (SCURP)

	Total	AIB	GoSL	Private Partner
ORIGINAL				
Component 1: Housing Construction	180	153	27	
Component 2: Land Redevelopment	45	35	5	5
Component 3: Technical Support and Project Management	16	6	10	
Front-end Fee	0.5	0.5		
Interest and Commitment Fee	5.5	5.5		
Total	247	200	42	5
REVISED				
Component 1: Housing Construction	127	108	19	
Component 2: Land Redevelopment	11	10	1	-
Component 3: Technical Support and Project Management	14	6	8	
Component 4: Emergency Health	70	70	-	
Front-end Fee	0.5	0.5		
Interest and Commitment Fee	5.5	5.5		
Total	228	200	28	-

Table 2: Reallocation of Loan Proceeds (SCURP)

Category	Original Allocation (USD million)	Proposed Allocation (USD million)	Percentage of Allocated Expenditures to be financed (exclusive of Taxes)
(1) Goods, works, non-consulting services, and consultants' services under Component 1 (Part A)	153	108	85%
(2) Goods, non-consulting services, and consultants' services under Component 2 (Part B)	5	4	100%
(3) Works under Part B	30	6	86%
(4) Goods, works, non-consulting services, and consultants' services under Component 3 (Part C)	6	6	100%
(5) Front-end Fee	0.5	0.5	
(6) Interest and Commitment Fee	5.5	5.5	
(7) Goods, works, non-consulting services, and consultant's services under Component 4 (Part D)		70	100% (inclusive of taxes)
Total amount	200	200	

Table 3: Proposed Changes to Project Cost (RLVMMP)

	Total	AiIB	GoSL
ORIGINAL			
Component 1: Implementation of Mitigation Measures	97	70.5	26.5
Component 2: Enhancement of Policy Standards and Institutional Capacity	3	2.4	0.6
Component 3: Provision of Essential Facilities and Equipment	2.5	2.0	0.5
Component 4: Technical Support and Project Management	4.5	2.1	2.4
Front-end Fee	0.2	0.2	0
Interest and Commitment Fee	2.8	2.8	0
Total	110	80	30
REVISED			
Component 1: Implementation of Mitigation Measures	59.2	41.4	17.8
Component 2: Enhancement of Policy Standards and Institutional Capacity	2.5	1.9	0.6
Component 3: Provision of Essential Facilities and Equipment	2.1	1.6	0.5
Component 4: Technical Support and Project Management	4.5	2.1	2.4
Component 5: Emergency Health	30	30	0
Front-end Fee	0.2	0.2	0
Interest and Commitment Fee	2.8	2.8	0
Total	101.3	80	21.3

Table 4: Reallocation of Loan Proceeds (RLVMMP)

Category	Original Allocation (USD million)	Proposed Allocation (USD million)	Percentage of Allocated Expenditures to be financed (exclusive of Taxes)
(1) Goods, works, non-consulting services, and consultants' services for the Part A.2 and 3 of the Project	70.5	41.4	84%
(2) Goods, non-consulting services, and consultants' services and training for Part B of the Project	2.4	1.9	92%
(3) Goods and non-consulting services for Part C of the Project	2.0	1.6	92%
(4) Goods, non-consulting services, and consultants' services for Part D of the Project	2.1	2.1	100%
(5) Front-end Fee	0.2	0.2	
(6) Interest and Commitment Fee	2.8	2.8	
(7) Goods, works, non-consulting services, and consultant's services for Part E (Emergency health component)		30	100% (inclusive of taxes)
Total amount	80	80	

- 4) **Changes on the scope of the original activities.** Due to the allocation of funds to the emergency health component, the scope of original activities will be scaled down. The following Table 5 and Table 6 illustrate the changes of result indicators, which indicate the extent of scaling down of original activities. A new intermediate result indicator is proposed to be added to reflect the new emergency health component.

Table 5: Proposed Revision of the Results Framework (SCURP)

NO.	INDICATORS	Unit	Original Target	Revised Target
	Project Objective Indicators			
1	Aggregated number of beneficiaries (households) that move from underserved settlements to newly constructed housing with improved utilities and facilities and under improved resettlement practice	households	>5000	>4000
2	Improved URP policies (including resettlement, transfer and maintenance) adopted	Yes /No	Yr.3/ Yes	Yr.4/ Yes
3	% of value increase of the land made available for redevelopment under the project compared with the government's baseline price	%	Yr.3/30 %	Yr.5/30 %
4	4. Updating the City Guidance Plan of Colombo (P=in Preparation, A=Adopted)	P/A	Yr.4/ A	Yr.4/ A
	Intermediate Results Indicators			
1	Aggregated number of housing units constructed using the improved technical design and standards	units	5500	4100
2.	Area of redeveloped land used for public and high-value uses	Acres	>92	>10
3	Percentage of solid waste management (SWM) grievances addressed.	%	Yr.3/50	Yr.4/50
4*	The number of health institutions/hospitals benefitting from the emergency component	Number		490

Note: * additional indicator

Table 6: Proposed Revision of the Results Framework (RLVMMP)

NO.	INDICATORS	Unit	Original Target	Revised Target
Project Objective Indicators				
1	Aggregated number of direct project beneficiaries (of which female number)	Person	15000 (7500)	10000 (5000)
2	Area of road protected by implementation of mitigation measures	Square meters	35000	23000
3	Length of railway protected by implementation of mitigation measures	Meters	2280	2200
4	Climate resilience standards and specifications related to landslide mitigation has been adopted	Y/N	Adopted	Adopted
5	Land use guidelines in landslide prone area has been reviewed and recommendations have been submitted by the Steering Committee to the government for endorsement process	Y/N	Y	Y
6	Aggregated number of the planned resettlements to be avoided	No. of households	5000	3400
Intermediate Results Indicators				
1	Landslide mitigation schemes constructed to protect homes, agricultural land and economic activities using improved designs and standards	No.	147	100
2.	Grievances registered related to delivery of project benefits has been resolved	%	80	80
3*	The number of health institutions/hospitals benefitting from the emergency component	Number		210

Note: * additional indicator

- 5) **Adding Ministry of Health as a new agency** to implement the emergency health component.

28. Initial Assessment on Implementing the New Emergency Health Component

1) Implementation Arrangements. The Ministry of Health (MOH) will have overall responsibility for project implementation and oversight of the project activities for the emergency component. Particularly, MOH will be responsible for all procurement activities, coordination within the government and with stakeholders, reporting, and monitoring and evaluation. Currently, MOH, through an established Project Management Unit (PMU), is implementing an ADB-funded project: Health System Enhancement Project (HSEP), which also will provide funds for urgent medical needs of Sri Lanka. To improve the efficiency of implementation, AIIB and ADB signed an MOU to enhance the coordination on their parallel supports, and it is agreed in the MOU that the PMU of HSEP will also implement the activities in the AIIB emergency health component. The PMU of HSEP is very experienced with project operations following MDB's requirements; however, it is noted that the capacity and manpower of the PMU need to be enhanced to accommodate the additional workloads. AIIB is requesting MOH to further enhance the PMU's capacity and will provide necessary resources to provide support.

- 2) **Environmental and Social.** AIIB's Environmental and Social Framework (ESF) will be

applied for this health component. Activities under this component will have net positive impacts as they will improve capacity for containment of disease. The new emergency component will only entail purchases and distribution of medical supplies and pharmaceuticals. Since the activities under the new emergency component are likely to have minimal or no adverse environmental and social impacts, falling in Category C, it is envisaged that there is no change to the project's E&S category to a higher level. Tracking beneficiaries in a gender-disaggregated manner will be explored during implementation.

- 3) **Procurement.** The MOH, through the existing PMU, will be responsible for procurement of the emergency component, who has experience in implementing ADB financed Projects. A fast-tracked procurement risk and capacity assessment will be conducted to assess if any external experts or consultants are required for procurement support. The MoH is currently in the process of identifying and preparing the list of urgent medical needs, upon finalization of which a draft Procurement Plan (PP) and Project Delivery Strategy (PDS) will be prepared to identify the procurement arrangement and strategies required. The PDS and PP will be finalized during Project implementation. In line with the AIIB's Notes on Application of Procurement Policy to Emergency Operations, simplified procurement methods such as Direct Contracting, Request for Quotations, Consultant's qualification-based selection, limited tendering and shorter tendering periods will be allowed for procurement under the new component. For direct contracting, the options of using suppliers/firms with existing contracts for similar procurement may be considered subject to meeting the Bank's core procurement principles and standards. To expedite the procurement process, prior review of tenders and contract awards will be conducted where practicable, otherwise all contracts will be subject to post during implementation. The Bank will discuss the possibility of shortening the internal procurement approval processes of the MoH to expedite procurement under this component.
- 4) **Financial Management.** The Financial Management (FM) responsibility for the emergency component rests with the MOH. The MOH, through the existing PMU, has experience implementing ADB financed projects. Considering that the project is being processed under emergency procedures, the FM assessment will be fast tracked to identify any risks and finalize at minimal, the staffing, funds flow and disbursement arrangements. A review of other Multilateral Development Bank's FM assessment of the PMU will also be done to identify any immediate risks, to which AIIB will design appropriate mitigants. As part of the Bank's approach for monitoring the adequacy of the FM arrangements, a detailed assessment will be done during implementation. At such time, any required support to enhance the FM arrangements will be agreed on in a timebound action plan
- 5) **Disbursements.** The disbursement methods to be applied to the emergency component include advance, direct payment, reimbursements, and special commitments. For the advance method, a US dollar Designated Account (DA) will be set up to receive funds from the AIIB. Funds will be advanced from the DA to the Project Account to meet the estimated expenditures. From the Project Account, payments will be made

to suppliers, vendors, and consultants. In addition, Direct Payment or Special Commitment disbursement methods will be used under the emergency component, where payments need to be carried out for international open or limited and direct selection contracts, which would be identified in the procurement plan. The reimbursement method will be applied to retroactive financed expenditures for the emergency component. Retroactive financing up to 20% of the total financing amount of the emergency component will be allowed for eligible expenditures incurred since July 1, 2021. The eligible expenses are to be disbursed from the loan proceeds of RLVMMMP before from SCURP.

5. Approval Sought

29. As the proposed changes are material with respect to section 3.5.3 of the Bank's OPF, the Board of Directors is hereby requested to approve the changes to the projects as outline above.

Annex 1 Economic Outlook of Sri Lanka

1. **Background:** Sri Lanka is a lower-middle income country with a per capita GDP of around USD 3,700 and population of around 22 million in 2020. After emerging from more than a quarter century civil war in 2009, Sri Lankan economy grew at a healthy rate of 6.5 percent between 2010 and 2015, on average, reflecting peace dividend and a sustained policy thrust towards reconstruction and growth. This was accompanied by a gradual transition from a rural based production economy to a more urbanized economy driven by manufacturing and services. Sri Lanka has also made notable progress in reducing poverty, with the poverty rate (measured at USD 3.20 per day) declining from 19.9 percent in 2009 to 11 percent in 2016.

2. **Pre-pandemic:** To support macroeconomic stability and counter a difficult external environment, the authorities undertook an IMF-supported adjustment program in 2016. While there was some progress in the initial years, several domestic and external shocks in the subsequent years led to significant weakening of the economy. These shocks included a drought in 2017, a political crisis in 2018 and a terror attack in 2019. Growth slowed and while the public debt surged. Importantly though, vulnerabilities were further exacerbated by a series of large tax cuts and other fiscal easing measures, introduced in November 2019, including reducing personal and corporate income tax, reducing VAT rates, increasing tax exemptions, and discontinuing the automatic fuel pricing mechanism. These measures constituted a major reversal in fiscal consolidation, undermined the fiscal space, and complicated the situation under the IMF program, which ultimately expired in June 2020. Thus even prior to the COVID-19 pandemic the Sri Lankan economy was facing significant challenges.

3. **The COVID-19 pandemic:** Sri Lanka was relatively successful in containing the first outbreak with less than 3,500 cases by end of September 2020 by imposing strict containment measures. Along with nationwide lockdown, a ban on air passenger arrivals was introduced in mid-March 2020 (and lasted till January 2021). The subsequent waves proved to be more menacing with over 80,000 cases between October 2020 and February 2021 and around 425,000 cases between April and October 2021 caused by the Delta variant. Since the second wave, the government's strategy has been to avoid blanket nationwide lockdowns, to minimize economic damage, and go for "smart" and localized containment instead—these were introduced and lifted as necessary. Most containment measures and border restrictions were eased in October 2021 resulting in an improvement in mobility indicators. There has been a mild increase in cases in the turn of 2022 (Omicron), but no more stringent containment measures. This was helped by a successful vaccination campaign—by March 2022 nearly 80 percent of the population had received at least one dose, while more than 66 percent of the population was double vaccinated.

4. **Policy response to the pandemic:** The government introduced a wide range of relief measures. Discretionary fiscal measures were modest (due to constrained fiscal space) and amounted to around 1 percent of GDP. These included tax exemptions to critical medical imports, extension of tax payment deadlines, waivers on SMEs arrears and some tax penalties, grace period for payment of eligible utility and credit card bills, a ramp-up in pandemic-related spending, cash transfers and advances to eligible household, etc. Monetary response included debt repayment moratoria on bank loans for pandemic-affected sectors (such as tourism) between March 2020 and September 2021, rescheduled non-performing loans, new refinancing and concessional lending facilities, a reduction in the policy interest rate, relaxation of capital conservation buffers and loan classification rules, etc.

5. **Economic impact of the pandemic:** The pandemic was yet another in a series of recent large shocks to Sri Lanka. It resulted in a sharp economic contraction, of 3.6 percent in 2020. Construction, manufacturing and transportation experienced significant downturn, but the most consequential and lasting impact was from a collapse in tourism revenues, a mainstay of the economy, which all but evaporated overnight. The recession led to sharp jobs and earnings losses in the informal sector as well as some formal sectors. As a result, poverty is estimated to have increased by around 3 percentage points, to around 12 percent in 2020. Subdued demand kept inflation low in 2020. The current account deficit also moderated in 2020 as the decline in exports was offset by higher remittances and lower import bill due to lower commodity prices, demand contraction and import restrictions. However, the fiscal deficit widened sharply to 12.8 percent of GDP mainly driven by a collapse in revenue due to the impact of the pandemic but reinforced by the extensive 2019 tax cuts. This resulted in a further sharp increase in public debt, to 110 percent of GDP in 2020.

6. Importantly, however, Sri Lanka lost access to international capital markets, with yields rising to prohibitively high levels. Investors lost confidence in Sri Lanka's creditworthiness in the face of high deficits, high debt, the steep near-term redemption schedule, government's resolve to persevere with tax cuts and expansionary policies, as well as the failure to secure IMF's emergency financing. In September, Moody's downgraded Sri Lanka's sovereign rating to the CCC range, citing heightened liquidity and external risks due to limited secured funding sources and the impact of the pandemic.

7. **Recent developments.** For some time, Sri Lanka has been able to navigate through the liquidity crunch. The decisive outcome of the August 2020 elections removed political uncertainty. Economic activity had normalized. Exports had recovered, while imports remained subdued, partially due to strict BoP restrictions imposed to protect external liquidity. These included restrictions on import of non-priority goods (mainly personal vehicles), repatriation and surrender requirement for export proceeds and worker remittances, and restrictions on outward transfers of funds for emigrants. Disbursement on existing official project loans was accelerated while financial support from China, India, Bangladesh and the new SDR allocations provided some temporary respite.

8. However, the situation had been deteriorating through 2021. The recovery has proven to be underwhelming, at 3.6 percent, amid continued infection outbreaks, insufficient recovery in the tourism sector as well as due to import constraints. Sri Lanka's GDP remains below pre-pandemic levels. The current account deficit widened significantly in 2021, to an estimated 3.8 percent of GDP, due to high global fuel and commodity prices and growing demand. The fiscal deficit remained very large, at over 11 percent of GDP, due to further deterioration in revenues (as a share of GDP) and despite expenditure restraint. The large fiscal deficit has been financed entirely from domestic sources, including by credit from the central bank. Public debt increased to almost 120 percent of GDP—an extremely high level. Inflation increased to double-digits, due to supply constraints, some currency depreciation, the monetary expansion and high commodity prices.

9. Moreover, being cut from international capital markets, Sri Lanka has been financing its maturing external obligation, including Eurobonds, directly from reserves. Since mid-2021, the exchange rate has been quasi-pegged to the USD, which prevented an orderly BoP adjustment. By March 2022, foreign reserves fell to critically low levels—below USD 2 billion, which is below one month of import and around 15 percent of IMF-recommended minimum safe levels. FX shortages have led to the emergence of a parallel FX market, high import costs, acute shortages of essential commodities (such as rice, milk powder, fuel and cooking gas), even higher inflation, and a sharp decline in official remittances, which shifted to informal channels.

10. In the first quarter of 2022, the situation has turned into a crisis. In April 2022, both the World Bank and IMF further downgraded global growth for 2022 and 2023. Economies in all stages of development are facing commodity price increases, and the outlook for external demand has weakened. Social unrest erupted over acute shortages and high prices of essential commodities, including food and fuel, and regular power blackouts. Due to low reserves, the currency peg was no longer tenable—the exchange rate fell sharply, by 45 percent. To contain the fallout the central bank raised the policy interest rate by 700 basis points. Inflation hit 30 percent (46 percent for food) in March 2022. In April, the government felt compelled to prioritize emergency spending over debt service and announced a default on its external obligation.

11. The debt suspension will continue pending an orderly restructuring of those obligations in a manner consistent with an economic adjustment program supported by the IMF, expected to be worked out in the next several weeks or months.

12. **Debt Sustainability:** As of February 2022, the IMF assessed Sri Lanka's public debt to be unsustainable. The risks have only increased since.

13. Sri Lanka's public debt had steadily increased to almost 120 percent of GDP in 2021 (including guarantees). Due to the recent devaluation, it is bound to increase further. Factors driving the increase in debt include weak progress on fiscal consolidation, with frequent policy reversals (particularly the large tax cuts of 2019), sluggish growth since 2016, steady depreciation of the currency, greater emphasis on external borrowing (including bilateral currency swap arrangements), as well as the impact of the pandemic. The worsening macro-fiscal conditions have resulted in a credit downgrade by all major credit rating agencies.

14. Around 40 percent of public debt is external, while around 60 percent is domestic, owed mainly to commercial banks and the central bank. Contingent liabilities (in the form of guarantees to SOEs, especially in the energy and air transport sector) are substantial and could materialize.

15. IMF's assessment of "unsustainable debt" means that fiscal consolidation efforts necessary to bring down debt over the coming years to safe levels would be too large to be economically and politically feasible. That means that debt restructuring is necessary.

16. Otherwise, debt would continue to grow, even despite sharply reduced deficit. The required financing needs would exceed domestic financial system's capacity and either suffocate private credit growth or require further monetary financing, which would undermine monetary stability. At the same time sufficient and affordable external financing is unlikely to be forthcoming in such scenario. In the absence of this additional external financing, a disorderly adjustment would involve severe import compression, external arrears and social hardships.

17. **Outlook:** There is currently high uncertainty around the outlook for the Sri Lankan economy. While devaluation may boost exports, it will entail a significant dislocation in the economy.

18. The priority should be on shielding vulnerable groups from the current crisis to the extent possible, and designing a credible and coherent strategy to restore macroeconomic stability and debt sustainability. Such strategy will need to include debt restructuring, a decisive, revenue-based fiscal consolidation via permanent measures (including mobilizing taxes), and a flexible, market-determined exchange to facilitate external adjustment.

19. The authorities are currently in discussions with the IMF for an adjustment program. Meanwhile the program (and the needed debt restructuring) is being negotiated, and once the authorities have credibly committed to the necessary adjustment, Sri Lanka would need bridge financing to shore it up through the crisis, help sustain imports of essential goods and protect the vulnerable population. As of February 2022, the IMF estimated the fiscal financing gap to be around USD 4.9 billion, or around 5 percent of GDP, per year over the near term.