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UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY

AGENCY FOR INTERNATIONAL DEVELOPMENT

WASHINGTON, D.C. 20523

PROGRAM ASSISTANCE APPROVAL DOCUMENT

SRI LANKA

MAHAWELI SECTOR SUPPORT

383-0078

APRIL 1981

CLASSIFICATION: Unclassified

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PAAD

DEPARTMENT OF STATE
AGENCY FOR
INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE
APPROVAL DOCUMENT

1. PAAD NO. 383-0078

2. COUNTRY Sri Lanka

3. CATEGORY Local Currency Sector Support - USLC

4. DATE March 11, 1981

5. TO: Mr. M. Peter McPherson
Administrator

6. OYB CHANGE NO. N/A

7. FROM: Frederick W. Schieck
Acting AA, Bureau for Asia FWS

8. OYB INCREASE

TO BE TAKEN FROM: N/A

9. APPROVAL REQUESTED FOR COMMITMENT OF: $50,000,000 ($18.8 million in FY 81, balance in FYs 82, 83)

10. APPROPRIATION - ALLOTMENT Development Assistance - Section 103

11. TYPE FUNDING: [X] LOAN [ ] GRANT

12. LOCAL CURRENCY ARRANGEMENT: [ ] INFORMAL [XX] FORMAL [ ] NONE

13. ESTIMATED DELIVERY PERIOD N/A

14. TRANSACTION ELIGIBILITY DATE Approval Date

15. COMMODITIES FINANCED

N/A

16. PERMITTED SOURCE	17. ESTIMATED SOURCE
U.S. only:	U.S.: $50,000,000 through USLC
Limited F.W.:	Industrialized Countries:
Free World:	Local:
Cash:	Other:
Code 000 USLC	

18. SUMMARY DESCRIPTION

This loan will provide $50 million in local cost financing for the Mahaweli development program over three fiscal years, FY 81-83. The purpose of the loan is to assist the Government of Sri Lanka to maintain an adequate level of local currency investment in the Mahaweli program during a period of extreme budgetary stringency. The rupees generated under the loan will be used primarily to finance "downstream" components of the Mahaweli irrigation/rural development scheme (e.g., farm-to-market roads, schools, community centers, on-farm irrigation ditches). Otherwise, these components, needed to bring the Mahaweli program's benefits to the rural poor, probably would have to be delayed significantly or eliminated from the program due to the need for the GSL to control deficit spending. Because this loan represents an additional U.S. commitment to the Mahaweli program, over and above the $85 million project loan pledged for canal construction, and because it will provide the GSL with a flexible means of financing local costs in the Mahaweli program, the GSL and A.I.D. have agreed to use unrestricted special letters of credit (USLCs) to generate rupees under this loan. The GSL will use the USLCs to finance purchases of goods and services in the U.S.

The Loan Agreement, which may be negotiated and executed by the officer to whom such authority is delegated in accordance with A.I.D. regulations and Delegations of

(continued on page 2)

19. CLEARANCES	DATE
A/AA/PPC:CPaolillo CP	4/1/81
GC:JRBolton JRB	3/13/81

20. ACTION

[X] APPROVED [ ] DISAPPROVED

M. McPherson
AUTHORIZED SIGNATURE

1 APR 1981
DATE

Administrator
TITLE

CLASSIFICATION: Unclassified

2

Authority, shall be subject to the following essential terms, together with such other terms and conditions as A.I.D. may deem appropriate:

A. The GSL shall repay the Loan to A.I.D. in United States Dollars within forty (40) years from the date of first disbursement under the Loan, including a grace period of not to exceed ten (10) years. The GSL shall pay to A.I.D. in United States Dollars interest from the date of first disbursement under the Loan at the rate of (a) two percent (2%) per annum during the first ten (10) years, and (b) three percent (3%) per annum thereafter, on the outstanding disbursed balance of the Loan and on any due and unpaid interest accrued thereon.

B. The GSL shall agree that subsequent increments of the Loan shall be subject, inter alia, to a review by A.I.D. of the internal and external economic and financial position of Sri Lanka to ensure that further assistance under the Program can and will be used effectively and continues to be required.

C. Local currency for which reimbursement will be made by A.I.D. shall be allocated in order of priority only to the following three categories of expenditures for the Mahaweli Program and shall be subject to the mutual agreement of the GSL and A.I.D. annually:

(1) downstream activities, such as land clearing, on-farm development, construction of social infrastructure (including schools, health centers and community centers), construction of farm to market roads, irrigation and drainage canals and construction of worker and settler camps, for which there is a demonstrated capacity of the GSL implementing agencies to perform such budgeting, supervisory, audit and other functions required to execute the activity without expatriate technical assistance;

(2) downstream activities for which expatriate assistance for design and supervision has been arranged under donor financing;

(3) headworks construction in the Mahaweli Program for which expatriate assistance for design and supervision is being provided with donor support.

D. The GSL shall agree to provide from its own budget, or cause to be provided by donors other than the United States, at least twenty-five percent (25%) of the total cost of any major project within the Mahaweli Program for which assistance is provided under this Agreement.

3/4

TABLE OF CONTENTS

MAHAWELI SECTOR SUPPORT

5

SUMMARY AND RECOMMENDATIONS

A. Recommendations:

$50,000,000 three year life-of-program loan with $18,800,000 to be obligated in FY 81 and the balance in FY 82 and FY 83.

2% interest during grace period, 3% interest thereafter.

40 year repayment period, including 10 year grace period.

B. Brief Description:

Why?

Upon assuming power after the 1977 elections, the current Sri Lankan Government promptly began to implement a series of liberalizing economic reforms designed to arrest the pattern of economic stagnation which had taken hold during the previous seven years. The reforms included unification of the exchange rate and devaluation, elimination of quantitative restrictions and license requirements for most imports, shifts from consumer subsidies to producer incentives, and encouragement of the private sector and foreign investment to stimulate growth instead of continued exclusive reliance on state enterprises. The Government also began making selected improvements in health, education and nutrition programs, focussing them more exclusively on the poor so as to maintain Sri Lanka's impressive record of social progress.

The Government's medium-term development strategy is to create greater employment opportunities, attain self-sufficiency in basic food items, diversify and increase exports, and improve economic and social infrastructure. The principal instruments for achieving these objectives are the GSL public investment program to finance infrastructure development and private sector incentives to increase production and exports. The Government has purposely pursued a very ambitious public investment program because investment previously had been ignored for so long. It has had remarkable success in attracting external financing for its program as donors have responded enthusiastically to GSL economic reforms. Today, three years after the Government began to implement its development program, its successes are considerable. Economic activity has greatly accelerated and employment levels are the highest they have ever been. Public investment in rural development, housing, industrial infrastructure and other areas increased from Rs.2.1 billion in 1977 to Rs.12.4 billion in 1980. After years of dormancy, the private sector is now vibrant. Foreign investment is beginning to pick up in response to the dramatic change in the business climate. Gross domestic product growth averaged an unprecedented 7.3% in 1978 and 1979, twice the 1970-77 rate.

These gains have not been accomplished without some adverse short-term economic consequences, however. The GSL has pursued an ambitious public investment program and rapid domestic economic adjustments in the face of a world-wide recession and accelerating inflation in the price of vital imports, as well as domestic resource shortages. This has resulted in large increases in the GSL budget deficits, the level of Government borrowing to finance these deficits, inflation, and the balance of payments deficit. The strains on both domestic and external resources reached critical thresholds in 1980 and the achievement of the Government's developmental objectives will be endangered unless the economy is carefully managed.

The Government, of course, realizes the painful economic choices it faces, and last November it took a courageous and necessary first step to reduce planned 1981 investment expenditures by 20%. In contrast to the last two years, the Government plans to enforce its investment expenditure ceilings much more strictly. In addition, the Ministry of Finance and Planning's investment strategy for 1981-85 is to retain the rupee investment levels shown in the 1980-84 plan for 1982, 1983 and 1984, and make upward adjustments for inflation only in relation to donor financing and changes in the exchange rate. This would result in lower real levels of investment. The only palatable way for the Government to maintain adequate investment levels to meet its development objectives will be to attract further donor assistance.

The Mahaweli Development Program commands the largest share of the GSL investment program. Through it, the Government hopes to obtain substantial increases in agricultural production, employment and power generation. It is a massive rural development effort aimed at assisting poor and landless farmers to better their lot. Support for the Mahaweli program is a key feature of AID's program in Sri Lanka to help increase rural production and employment. Assuming overall investment spending ceilings are maintained, if the Mahaweli program's share of the investment budget does not increase in the 1981-85 plan, the Mahaweli program as it currently is envisaged would be underfinanced by 38%, or by about $600 million. The only way the GSL will be able to reduce program cut-backs and/ or implementation delays, which can only be carried so far without endangering the program's viability, will be through additional donor assistance.

At the July 1980 meeting of the Sri Lanka Aid Group, AID and other donors recognized that new and more flexible assistance approaches would be required to respond to Sri Lanka's current needs. The IBRD recommended that donors shift from project aid to more rapidly disbursing assistance. During the last few years, AID has come to appreciate that the GSL's economic and social policies and its programs in key development fields are fully consistent with Agency goals and priorities. Consequently AID has a better chance of being able to increase assistance levels in Sri Lanka without increasing direct hire staff appreciably than in most other developing countries. In short, Sri Lanka's current development requirements, AID's program objectives in Sri Lanka, and one of AID's primary institutional objectives all will be served through the provision of sector support for the Mahaweli program.

<u>What?</u>

The purpose of this loan is to assist the GSL to maintain an adequate level of investment in the Mahaweli program during a period of strict budgetary stringency. The loan will provide the GSL with a non-inflationary means of financing Mahaweli investment within revised spending ceilings. Loan generated rupees will be allocated for specific downstream development components of the Mahaweli program to be included in the GSL's official annual investment budgets. This will help ensure that at least minimum funding adequate to provide for downstream development will be included in these annual budgets. Timely downstream development will be important if the GSL's large investment in irrigation infrastructure is to be made productive as soon as possible and the program's benefits are to reach the rural poor.

The loan also will have a beneficial impact on Sri Lanka's serious balance of payments situation. The dollars provided will help reduce the GSL's external financing gap and result in increased US exports to Sri Lanka.

<u>How?</u>

The proposed loan will be negotiated with the Ministry of Finance and Planning. The External Resources Department (ERD) of that Ministry will be responsible for administering the dollar financing. The Mahaweli Authority of Sri Lanka (MASL) will administer the rupee sector support.

Two methods of generating rupees for the Mahaweli program were initially considered: a series of cash transfers (direct purchases of rupees) and a commodity import program (CIP). Both would provide (a) a non-inflationary source of financing for the Mahaweli program, (b) relatively quick-disbursing balance of payments assistance, and (c) a means of increasing US exports to Sri Lanka, with as many as possible of these exports being intermediate and investment goods which will have a beneficial impact on Sri Lanka's development. The chief advantage of the cash transfer for the GSL and USAID is that it would greatly simplify administration of the dollar assistance, whereas an additional U.S. direct hire position would be required to help administer a CIP.

However, a major disadvantage of the cash transfer method is the lack of identification of AID dollars to U.S. exports. After an exchange of cables with the Mission and consultation with the GSL, it was decided that the irrevocable Unrestricted Special Letter of Credit (USLC) method of disbursing dollars would be most appropriate. (State 068450 March 18, Colombo 0786 February 13 and State 031152 February 6).

Rupees generated for Mahaweli sector support will be allocated each year in conjunction with the preparation of the GSL's annual Mahaweli investment budget. USAID will satisfy itself that the allocation of resources in the Mahaweli program is proper and reasonable and that downstream requirements are adequately covered. Rupees will be programmed as a first priority against downstream components which the GSL will be responsible to carry out on its own; as a second priority against downstream activities for which expatriate assistance for design and supervision is being provided with donor support; and if necessary as a third priority, against GSL financing requirements for headworks construction for which expatriate assistance for design and supervision is being provided with donor support. It is expected that almost all loan-generated rupees will be expanded for first priority downstream development activities in System B, C and H of the Mahaweli program. The specific uses of the rupees will be outlined in a Program Annex to each year's loan agreement/amendment which will include allocations against line items in the official GSL Mahaweli budget for specific activities.

AID will reimburse the GSL for expenditures of rupees made by the GSL after the signing of the loan for the agreed upon activities on a quarterly basis by issuing or amending the USLC opened in a U.S. bank. The USLC may be used by the Central Bank of Sri Lanka (beneficiary of the USLC) to pay for goods and services of U.S. source ordered or purchased after the USLC is opened. GSL accounting records will be used to show that the amounts budgeted from all sources of financing are expended for the purposes indicated and that the intended physical accomplishments have been achieved. Quarterly reports will be submitted to USAID to enable the Mission to monitor rupee expenditures and implementation progress.

C. <u>Summary Findings</u>

- Sector support for the Mahaweli program is required to help ensure that acceptable progress in that program is achieved.

- Balance of payment assistance also is urgently required.

- The provision of sector support for the Mahaweli program is an appropriate use for Section 103 development assistance funds in Sri Lanka; it is consistent with the Sri Lanka CDSS and directly responsive to recommendations made at the last meeting of the Sri Lanka Aid Group.

- The GSL possesses the capability to administer the support to be provided without additional technical assistance; and real rescurces can be mobilized for the Mahaweli program if such financing is provided.

- The use of USLC would fully meet the loan's objectives and simplify its administration.

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I. BACKGROUND AND RATIONALE FOR A NEW DEVELOPMENT ASSISTANCE APPROACH

A. Government of Sri Lanka Economic Policy Reforms

After nearly half a decade of economic stagnation in Sri Lanka, the current Government was overwhelmingly voted into office in 1977. This Government promptly implemented a series of major economic reforms. These included unification of the exchange rate and devaluation, elimination of quantitative restrictions and licensing on most imports, substantial increases in deposit and lending interest rates, shifts from consumer subsidies to producer incentives, creation of a favorable climate for foreign investment, and encouragement for the private sector to import and compete with state enterprises. At the same time, government health, education, and nutrition programs were selectively improved and focussed more exclusively on the poor so as to maintain Sri Lanka's impressive record on infant mortality, life expectancy, literacy and population growth (see Table 1). Because investment had been ignored for so long, a major shift in budget emphasis away from consumer subsidies in favor of public sector investment was implemented.

The economic reforms introduced in late 1977 have met with considerable success. Gross domestic product growth averaged an unprecedented 7.3% in 1978 and 1979, twice the 1970-77 rate. This was accomplished while the economies of a great number of other developing countries stagnated in the face of worldwide recession and inflation. The private sector's response to more liberal economic policies has been very encouraging, and foreign investment is picking up. The capital expenditure (public investment) budget increased from Rs.2.2 billion ($278 million) in 1977 to Rs.5.4 billion ($347 million) in 1978, Rs.7.3 billion ($475 million) in 1979 and Rs.12.8 billion ($798 million) in 1980. The GSL has mobilized substantial external support for its development program. For example, commitments by the Sri Lanka Aid Group grew from $384 million in 1978 to $567 million in 1979 and $740 million in 1980, reflecting strong support for the GSL's economic initiatives.

Sri Lanka has had to pay a price for these successes, however. Recent economic reforms and the ambitious public investment program have begun to strain the limits of available resources, and the GSL is now at a very critical point where sound management of the economy will be necessary if its development objectives are to be fully achieved. The Government is facing the situation squarely and requires additional, more flexible donor support if it is to succeed.

Table 1

Comparative Socio-Economic Indicators

Source: 1979 World Population Data Sheet Population Reference Bureau, Inc.

Region or Country	Population Estimate Mid-1979 (millions)	Birth Rate[1] (per 1000)	Death Rate[1] (per 1000)	Rate of Natural Increase (%)	Population in year 2000	Infant Mortality Rate[1] (per 1000 live births)	Population under 15 years (%)	Life Expectancy at Birth (years)	Physical Quality of Life Index[3]	Per Capita GNP[2]	Literacy rate (%)
1. Sri Lanka	14.5	26	8	1.8	20	51	39	68	82	200	80.9
2. Philippines	46.2	34	10	2.4	78	80	43	58	71	450	83.3
3. Thailand	46.2	32	9	2.3	76	68	43	61	71	410	78.6
4. Indonesia	140.9	35	14	2.0	210	91	44	50	48	300	59.6
5. Pakistan	79.9	44	14	3.0	145	136	46	51	36	190	18.8
6. India	660.9	34	15	1.9	1011	122	41	50	41	150	33.4
7. Burma	32.9	39	14	2.4	53	140	40	51	50	140	59.7
8. Nepal	13.7	44	21	2.3	22	152	42	44	27	110	N/A
9. Bangladesh	87.1	47	18	2.9	155	153	43	46	32	90	N/A
Africa	457	46	17	2.9	831	143	44	47	33	450	
Latin America	352	35	8	2.7	597	86	42	62	71	1240	

Notes: 1. Data pertain generally to 1976 or 1977, but Sri Lanka data for these indicators are for 1974. Sri Lanka data for 1978 from the GSL Register are: Birth rate - 28.5; Death rate - 6.6; Rate of natural increase in population - 2.2; Infant Mortality - 42.4.

2. Most GNP data are for 1977 and have been "standardized" by the World Bank to take account of exchange rate changes, etc.

3. An index developed by the Overseas Development Council which combines infant mortality, life expectancy and literacy. See source above for details.

B. Current Economic Conditions

The year 1980 was a sobering one for GSL economic planners and policy makers. The 1980 CDSS for Sri Lanka stated that "the main economic problem facing the GSL is whether its ambitious development objectives can be achieved in a 4 to 5 year time frame in the face of accelerating inflation in the prices of vital imports ... as well as emerging domestic resource shortages". The events of 1980 confirm that the GSL's investment plans have been too ambitious. The strains on both domestic and external resources reached critical thresholds during 1980 and exhibited themselves through major increases in GSL budget deficits, government use of domestic credit to cover these deficits, inflation, and the balance of payments current account deficit.

1. The Government Budget and Inflation

Increased spending resulting from the accelerated GSL public investment program initiated in 1978 has led to increasing budget deficits which reached 43% of government expenditures in 1979 and an estimated 53% in 1980. Actual expenditures greatly exceeded those planned because many investment costs were underestimated due to both unanticipated inflation in critical areas such as construction and deficient program planning. Rather than reduce real levels of investment, line ministries obtained substantial supplemental budgetary allocations. Consequently, actual capital expenditures exceeded original budget estimates by 22% in 1979 and an estimated 51% in 1980. The GSL's efforts to reduce budget deficits are described on the next page.

These increasing budget deficits were financed largely through domestic borrowing. The share of the Government budget deficit financed by domestic credit creation was 52% in 1979 and about 51% in 1980. This increased domestic credit contributed to an increase in the money supply of 29% in 1979. The money supply would have increased by more than 40% in 1980, except that the impact of increased domestic credit was offset by a $200 million decrease in international reserves, which reduced the actual increase in the money supply in 1980 to 23%. Because the GSL exceeded the ceiling on domestic borrowing in its Extended Fund Facility (EFF) agreement with the IMF, the EFF was suspended in August, 1980.

The major concern which arises because of increases in budget deficits, domestic borrowing by the Government and the money supply is the consequent inflationary pressures they bring. Increased inflation can undermine the GSL's plans for the country's future economic growth and development. Government budget deficits tend to widen with inflation, and this could lead to a vicious circle of deficits contributing to inflation which in turn contributes to increased deficits. Inflation will tend to reduce the real levels of planned investments which can be achieved. It also may endanger the Government's liberalized exchange rate and trade policy reforms, depending on how far the GSL is willing to let its currency depreciate. Finally, inflation could have serious distributional impacts, causing a deterioration in the living standards of low-income groups.

The inflation rate as measured by the consumer price index reached about 30% in 1980. Until now, this high rate has been caused mostly by price decontrol, higher import prices, and increasing domestic resource shortages. These factors were in some cases uncontrollable or, in the case of price control, desirable from an overall economic policy viewpoint. The impact of increasing levels of domestic credit on inflationary growth in the money supply has been largely offset by declining levels of international reserves. The currently very low level of international reserves, however, will not allow such an offset in 1981.

No doubt with this fact in mind, and as a first step toward renegotiating an EFF agreement, the GSL made courageous decisions in November 1980 and March 1981 to reduce planned 1981 investment expenditures sharply from Rs.15.5 billion to Rs.12.0 billion. This level, only slightly lower than 1980, would result in a decrease in real investment. The 1981-85 investment plan issued in May 1981 however, reflects strategy of the Ministry of Finance and Planning to maintain the levels shown in current rupees for at least 1982, 1983 and 1984 and make upward adjustments for inflation only in relation to donor financing and changes in the exchange rate. (Shifts between sectors will be possible, of course). Even at these reduced real investr levels, and even if projected external financing is made available, substantial budget deficits are anticipated. The Government believes, however, that any further reductions in investment would seriously undermine its development program. The GSL thus finds itself facing a trade-off requi. ing careful balancing between the extreme of inadequate investment - with all that implies for economic and social development - and larger budgetary deficits and greater inflation.

2. The Balance of Payments

Sri Lanka's balance of payments deteriorated sharply in 1980. The current account deficit more than tripled from $228 million in 1979 to $644 million in 1980. International reserves were depleted by $220 during 1980. At the end of 1980 net international reserves were $38 million, equal to one week of imports; down from $258 million at the end of 1979.

Large increases in imports have been the major cause of the deteriorating current account balance. The current account deficit almost doubled from 1978 to 1979, while imports increased by 42% in value. The value of imports in 1980 increased by about

40% over 1979. About 75% of the increase in imports in 1980 was in intermediate and investment goods, mostly due to increased imports by the public sector primarily financed by foreign assistance. The remaining 25% of the increase was in consumer goods. The share of intermediate and investment goods in total imports has increased from 65% in 1979, to 70% in 1980 and 71% in 1981.

The disappointing performance of exports has also contributed to the worsening balance of payments situation. The 40% increase in imports in 1980 was accompanied by only a 9% increase in exports. Most disappointing has been the performance of estate crop exports for which only about 1% more was received in 1980, causing their share in total exports to decline from 65% in 1979 to 58%. The Government currently is taking steps to increase estate crop production and exports.

Another important factor adversely affecting the balance of payments is the worsening external terms of trade. The most dramatic recent development in the terms of trade was the more than doubling of oil import prices in 1980, which resulted in more than twice as much being spent on oil imports. Oil imports in 1980 accounted for about 47% of export earnings, compared to 26% in 1979. The prices of other imports needed for the investment program are also going up rapidly due to inflation in the industrialized countries.

Sri Lanka's external financing gap of almost $259 million in 1980 was financed mostly by drawing down reserves. There was also a sharp increase in the use of short-term trade credits, especially to finance petroleum imports.

Although import growth in 1981 is projected to decline to 7% and exports are expected to rebound slightly, the current account deficit is still expected to reach $769 million, and an external financing gap of $272 million is projected. The GSL will not be able to finance this gap by drawing down reserves since they are now at a very low level. Continued use of trade credits would be detrimental to Sri Lanka's debt service profile. Aside from any additional foreign exchange provided from new commitments of quick-disbursing aid, the resumption of the IMF Extended Fund Facility in June 1981 drastically reduces the excessive reliance on short-term trade credits. New commitments of quick disbursing aid will also be required, however, to help the GSL meet the large external financing gaps anticipated in the years ahead without having to depend entirely on the IMF or on less appropriate and more costly external borrowing.

More detailed analyses of the GSL budget, inflation and the balance of payments are provided in Annexes 1 and 2.

C. GSL Investment Program and the Mahaweli Development Program

The GSL's medium-term development strategy is aimed at reducing high unemployment levels from an estimated 20% in 1977 to 9% in 1983; attaining self-sufficiency in basic food items; diversifying and increasing exports; and improving economic and social infrastructure. The principal instruments for achieving these objectives are the capital expenditures budget, which finances infrastructure investment and private sector incentives to increase production and exports. The capital expenditure budget also has a direct effect on employment through the creation of over a million jobs.

The GSL's strategy is explained in its rolling, five-year investment program which guide financial commitments for public investment projects. It includes both domestic and externally financed public investments and is composed of two major groupings: three lead projects and all other public investment. The lead projects are the Accelerated Mahaweli Program (AMP), Housing and Urban Development, and the Greater Colombo Economic Commission (Investment Promotion Zones). The lead projects accounted for 46% of total planned public investment in the 1981-85 investment program.

Within the lead projects, the Accelerated Mahaweli Program is the effort upon which the GSL pins its hopes for substantial increases in agricultural production, employment, and power generation, and for assisting poor and landless farmers to better their lot. It accounted for 38% of public investment in the 1981-85 plan. The AMP is intended to: (a) provide a livelihood to over 100,000 families (500,000 people) to be settled on newly irrigated land; (b) provide employment for up to 75,000 construction workers and possibly as many as 100,000 other off-farm workers; (c) increase food production by over one-half million tons annually; and (d) generate 500 megawatts of hydro-power, enough to meet the country's needs until the early 1990's.

Even with the very significant increases in donor support the Government has attracted for its development program, the originally planned level of public investment is seriously underfunded. Initial budget estimates for the 1979-83 investment program were Rs.47 billion ($3.0 billion). Given recent levels of domestic inflation and import price increases it is now estimated that the cost of fully executing the level of investment included in that program would be $6.75 billion. The Sri Lankan economy cannot support the level of public investment initially projected, and the Government must reduce its planned outlays accordingly.

The analysis of Mahaweli program funding requirements in Annex 3 estimated that the Mahaweli program would require about $1.6 billion during the 1981-85 period if all program components were implemented as currently planned without regard to financial constraints. However, if the Ministry of Finance's tentative strategy for limiting overall investment expenditures were to be applied to the Mahaweli budget, only about $1 billion would be made available during the 1981-85 period, leaving the program 38% under-financed. The GSL can reduce this shortfall (a) by increasing spending ceilings for the program through attracting additonal donor support, cutting other planned investment, or augmenting domestic borrowing; and/or (b) by eliminating or delaying implementation of certain Mahaweli program components. The Government has begun to take action along these lines, but the developmental, political and fiscal consequences of each of these alternatives will be very difficult for it to balance, and it is safe to say that even if the GSL squarely faces the tough decisions which lie ahead, the viability of Sri Lanka's most important rural development scheme will be endangered unless additional external financing is provided.

D. Implications for AID Assistance

In light of the large domestic and external resource gaps facing the GSL, and the serious implications this has for the success of Sri Lanka's most important development project, USAID/ Sri Lanka proposes the initiation of non-project assistance designed to provide sector support for the Mahaweli program. The proposed loan also will have a beneficial impact on Sri Lanka's balance of payments.

Non-project assistance focused on the Mahaweli program is consistent with AID's assistance strategy for Sri Lanka and the flexible position AID took following the last Sri Lanka Aid Group meeting concerning possible modifications in U.S. assistance in response to changing conditions in Sri Lanka. The principal objective of the CDSS for Sri Lanka is to increase rural production and employment. Support for Mahaweli is considered the key to achieving this objective. In its report for the July 1980 Aid Group Meeting*, the World Bank pointed out the growing requirement for external support to finance planned investment, especially in the lead projects, and noted the deteriorating balance of payments situation. Under the circumstances, and given the full support of Aid Group members for the GSL's development policies, the Bank recommended that donors shift from project assistance to more rapidly disbursing aid. The proposed AID loan will directly respond to current Sri Lankan requirement by providing vitally needed financing for the Mahaweli program and balance of payments support.

The use of development assistance funds for non-project assistance is appropriate for Sri Lanka because:

1

(1) Sri Lanka's development policies and programs, as they are currently being carried out, enjoy the full support of the international donor community. The Government is fully committed to providing the benefits of development to low income groups, while pursuing economic growth.

(2) The GSL is experiencing extreme budgetary shortfalls and without additional assistance will be prevented from carrying out its development program. External support for local cost financing will enable the GSL to pursue its investment program with less inflationary domestic credit creation.

(3) Quick-disbursing balance of payments assistance is urgently required.

(4) Real domestic resources can be mobilized to implement planned Mahaweli activities if additional financing is provided.

(5) The GSL is capable of implementing selected important Mahaweli activities without additional expatriate technical assistance.

The specific characteristics of the proposed loan are explained in Part II.

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* Report No. 2955-CE, Sri Lanka : Key Development Issues in the 1980's, Volume I: The Medium Term Development Program.

II. PROPOSED ASSISTANCE

A. Purpose

The purpose of the proposed loan is to assist the GSL to maintain an adequate level of investment in its most important development project (Mahaweli) during a period of strict budgetary stringency. The loan will provide the GSL with a non-inflationary means of financing the Mahaweli program within revised budgetary ceilings. In addition, the loan will have a beneficial impact on Sri Lanka's balance-of-payments. The dollars provided under the loan will help reduce Sri Lanka's external financing gap and result in increased U.S. exports to Sri Lanka.

B. Mahaweli Assistance Objectives

It has become clear that the GSL will have to revise its implementation plans for Mahaweli significantly in order to remain within the budgetary ceilings imposed on the program, even if those ceilings are raised by cutting back other investment in favor of Mahaweli. If additional external assistance is not forthcoming, the GSL will have little choice but to stretch out implementation of the program further. After delaying headworks construction as much as possible, it would be necessary to delay downstream development activities needed to make the Government's large investments in irrigation infrastructure productive, and bring the program's benefits to the rural poor. If the delays made in implementation of downstream activities were significant, the implementation pace of the left bank in System B, for which AID is making a project loan, could also be affected since GSL financing will be required for downstream settlement and other costs simultaneously with AID's financing of canal construction. That project's current estimated cost is $218 million, of which AID will be contributing $85 million.

USAID therefore will allocate the rupees generated under this loan with a twofold objective: (a) to help ensure that minimum necessary funding is provided for the total Mahaweli budget within the GSL's revised investment spending ceiling; and (b) to ensure adequate attention to downstream development is reflected in the Mahaweli Authority of Sri Lanka's (MASL) allocation of funds within its annual budgets. This will be accomplished through the rupee allocation process described in Part III.

C. Effect of the Laon on the GSL Budget, Inflation and the Balance of Payments

This loan will enable the GSL to increase annual Mahaweli budgets above the levels which would be possible without this loan, without increasing domestic borrowing and inflation. Another way of looking at the effect of the loan on the Mahaweli budget is that it will reduce the level of real cuts the GSL will have to make in the Mahaweli program to stay within revised investment ceilings. AID (and other donors) are interested in seeing that the GSL provides adequate funds for the Mahaweli program within its annual ceilings, if necessary by cutting back other investment. Decisions on the overall level of investment spending and the priority given to the Mahaweli program, however, are best left to the GSL. During the annual exercises to program this loan's proceeds, AID and the GSL will review the levels of funding to be provided for the Mahaweli program, especially the financing requirements for downstream development which will more directly affect the near-term prospects for increasing agricultural production. The provision of funds reserved for these components of the program should be of significant help to the GSL in maintaining at least minimum necessary levels of investment on downstream development.

The rupee proceeds of the loan will reduce the amount of domestic borrowing the GSL otherwise would have to do to finance a given level of expenditures. For example in 1981, approximately 7.2% of the domestic borrowing the GSL would otherwise have to do to cover its projected deficit would not be necessary. The intent is not to provide rupees which will allow the GSL to exceed those annual investment ceilings once they are set. Once overall investment expenditure ceilings are set, the net effect of the loan will be deflationary. To insist that loan-generated rupees be used to increase Mahaweli spending above approved budget levels, without corresponding reductions elsewhere in the GSL budget, would negate its deflationary impact.

With regard to the balance of payments, the addition of $18.8 million in 1981 to Sri Lanka's foreign exchange resources will not be large in relation to total foreign exchange flows. However, when compared to the 1981 unfinanced external funding gap of $272 million projected in Annex 2, it is not insignificant. Indeed, only through increments of $10 to $20 million in non-project assistance from various other donors can the GSL hope to close this gap without having to depend entirely on IMF assistance and more costly foreign credit.

D. <u>Rupee Generation Alternatives</u>

The primary objective of the proposed loan is to generate rupees to finance investment in the Mahaweli program. The method by which these rupees are generated should meet the following objectives: (a) the rupees should provide a non-inflationary source of financing for the Mahaweli program; (b) the balance of payments assistance should be relatively quick-disbursing; and (c) the dollars should result in increased US exports to Sri Lanka. Two methods were initially considered: a series of annual cash transfers (direct purchase of rupees) and a commodity import program (CIP). While both mechanisms would meet the objectives listed above, both have shortcomings which resulted in a third method finally being adopted (unrestricted special letter of credit).

1. Cash Transfers

Cash transfers have been used in the past primarily for non-developmental purposes for both balance-of-payments assistance and budget support. However, USAID considered a departure from existing policy to permit the use of cash transfers for developmental reasons might be justified because of the GSL's excellent developmental policies and record of achievements, its need for timely balance-of-payments support, and AID's desire to manage a larger assistance program in Sri Lanka without increasing U.S. direct hire staff substantially.

USAID proposed that the cash transfer include a condition that non-concessionally financed imports from the U.S. be increased by an amount equivalent to the cash transfer. The GSL informally indicated that this condition would be acceptable and could be met.

Use of cash transfers would meet the primary objective of the loan. The chief advantage cash transfer method would have for the GSL and USAID is that it would greatly simplify administration of the dollar financing, thereby avoiding the assignment of an AID commodity procurement officer to Colombo. In addition, since rupees could be generated immediately following each cash transfer, the GSL's internal financial burden of financing Mahaweli expenses could be eased.

2. Commodity Import Program

Preparatory work for a CIP was done in case that method was chosen. USAID prepared an initial positive list of commodities required by state corporations and other public entities which the U.S. could supply competitively. The import program would have been aimed at meeting public sector import needs, at least initially, because private importers would have no incentive to use the CIP under the GSL's current liberalized foreign exchange procedures.

The CIP would also have met the same objectives listed for the cash transfer method. However, CIP would have placed a much greater administrative burden on the GSL and USAID than cash transfers since the USAID and GSL would have to ensure that all the requirements of Regulation 1 were followed. This would require a U.S. commodity procurement specialist added to the USAID staff.

3. Unrestricted Special Letters of Credit (USLC)

The Asia Bureau's Project Appraisal Committee (APAC), in reviewing the draft PAAD, wanted to select a financing method which would ensure that all or most of the AID dollars would be spent in the U.S. APAC felt that the U.S. import condition proposed for the cash transfer approach would be difficult if not impossible for the GSL to meet over the life of the loan. APAC further supported the USAID's concern that the use of CIP would unnecessarily complicate the administration of the loan and would divert attention from the focus of the loan; i.e. the use of rupee generations for downstream development in Mahaweli. Therefore APAC proposed that unrestricted special letters of credit be used to generate rupees for Mahaweli Sector Support. (State 031152, Feb. 6, 1981).

Since the SLC method has not been used by AID for several years, a further exchange of cables and discussions with GSL were necessary before the details could be worked out (Colombo 0786, February 13, 1981 and State 068450, March 18, 1981).

E. Size of Loan

The initial planning was for a $100 million loan to be incrementally funded over five years. This amount was based on (a) the total projected 1981-85 GSL rupee-financing requirement ($446 million) for the three types of activities which the loan might finance, and (b) likely AID funding availabilities during the same period. However the GSL rupee financing needs for the Mahaweli program are much greater than the level of AID funding likely to be available over the next five years.

APAC was reluctant to recommend approval of a five-year, $100 million loan, given the uncertainties of future AID funding and decided to reduce the level of the loan program to $50 million over a three year period with $18.8 million to be provided in FY 81. It was understood that the amount of the loan could be increased through PAAD amendment if conditions should warrant. (State 031152, February 6, 1981).

III. RUPEE USE AND IMPLEMENTATION PLAN

A. Mahaweli Activities to be Supported

Since the loan is to support GSL investment in the Mahaweli program, only Mahaweli line items in the capital expenditure component of the GSL's annual budget will be eligible for financing under the loan. Priority will be given to the following types of activities.

First priority will be given to downstream activities which meet the following criteria:

(a) costs are primarily of a local currency nature; and

(b) the nature of the activity is such that there is a demonstrated capacity on the part of GSL implementing agencies to satisfactorily perform such budgeting, accounting, design, contracting, supervisory, audit, and other functions as are required in the execution of the activity, without expatriate technical assistance.

These two criteria are satisfied for the following downstream development activities: land clearing, on-farm development (i.e. land leveling and construction of tertiary irrigation canals), and construction of social infrastructure (e.g. schools, health centers, community centers), farm-to-market roads, and worker/settler camps. Other cost items such as settlement costs and those associated with farmer training centers and farm machinery hire services also would be eligible.

This conclusion is based upon USAID's experience with the Mahaweli Authority of Sri Lanka (MASL) and familiarity with the budgeting, financial controls, engineering, contracting and construction supervision practices of the MASL, the Mahaweli Development Board (MDB) and other subsidiary Mahaweli agencies for similar work in systems H, B and C of the Mahaweli program. These basic types of construction activities are undertaken by the GSL without expatriate assistance throughout Sri Lanka. MASL budgeting procedures are improving as the Mahaweli program proceeds and good auditing practices are strictly observed by the GSL.

Second priority will be given to downstream activity components other than those covered under the first priority category where expatriate design and supervision assistance has been arranged under other financing(AID or other donors). The type of activities referred to here are basically primary and secondary irrigation and drainage canals and related construction.1/ If the schedule for

1/ An exception is the Minipe Anicut, Ulhitiya-Ratkinda reservoirs and associated works which are being carried out by the Mahaweli Development Board (MDB) with no expatriate assistance. The donor community generally, and USAID specifically, judges the MDB to have the capacity to satisfactorily perform work related to this component of the program.

implementation of first priority-type activities is extended because of economic conditions, construction capacity bottlenecks, or unforseen delays in execution of headworks and/or primary downstream irrigation works, it will be appropriate to use this loan to meet such second priority needs, subject only to the overall cost sharing limitations described below.

In the very unlikely event that the loan cannot be used for first and second category activities, third priority will be given to headworks construction in the Mahaweli program, again with the caveat that expatriate design and supervision already has been arranged under other donor financing.

Current projections for the financing requirements of the three categories of activities for the 1981-85 period are shown in Annex 3. A net amount of $141.6 million will be required from the GSL during 1981-85 to fully execute priority one-type activities. All of this will be required for local costs since the donor foreign exchange to be provided for these activities more than covers their foreign exchange cost.

For priority two-type activities, net GSL financing requirements will be $22.9 million. Here again, because donor contributions will more than cover foreign exchange costs, the entire amount will be required for local costs.

For priority three-type activities, the non-donor financed requirement is $485 million, of which $236.4 million (49%) is for foreign exchange costs and $248.6 million is for local costs.

For the three categories of activities together, the total GSL financing requirement over the 1981-85 period comes to $649.5 million, of which, $203.3 million will be required in foreign exchange and $446.2 million equivalent will be required in rupees. The $50 million equivalent in rupees generated under the proposed loan would represent 11.2% of GSL rupee financing requirements for the three categories in the absence of additional donor inputs for local costs over and above those shown in Annex 3.

Probably most of the $50 million will be used for priority one-type activities, which come to $141.6 million over and above present donor commitments. However, even if the GSL is unable to budget for all priority one-type requirements over the 1981-85 period, the AID input to the rupee financing requirements of the overall program would be relatively small.

A. Management of Rupees

1. Programming of Rupees - The anticipated generation of rupees for a given GSL budget year will be programmed at the time the MASL annual budget and those of its subsidiary agencies are prepared and will be shown against discrete line items in those budgets according to the priority uses of rupees described above. During the annual budget reviews and programming exercises, the Mission will satisfy itself that the allocation of resources in the Mahaweli program is proper and reasonable and that downstream requirements are adequately covered. As an additional impetus to the GSL to provide adequate amounts for downstream components, the loan agreement will contain a covenant whereby the GSL will agree to provide, or cause to be provided by other donors, at least 25% over the life of the project of the total cost of any project* within the Mahaweli program. Although such a provision is not required by Section 110(a) of the FAA since the Mahaweli program is a multi-donor effort, USAID feels it will be useful.

The actual obligation of U.S. dollar funds, including the agreement on the use of the rupees will take place after the GSL budget has been formally approved by Parliament and the specific uses of the rupees can be related to the official budget. The allocation of rupees may be reprogrammed by MASL at any time, subject to prior approval by the USAID.

The proposed 1981 program for the use of rupees, as shown in Annex 4 will be used as an annex to the initial loan agreement. Similar documents will be executed each year. The allocation of rupees to individual line items may be up to 100% of the amount budgeted for that item (see State 068450, March 18, 1981)

For 1982 and successive years' programming purposes, AID must establish with reasonable accuracy the anticipated obligation level under this loan for the following calendar your (GSL fiscal year is the same as the calendar year) in the preceding year, when MASL and other public sector agencies prepare their draft budgets for consideration by the Ministry of Finance. Thus for the initial programming of funds for 1982, it will be desirable to have an estimate of the AID FY 1982 obligation level in May 1981. The GSL must clearly understand that if the amount finally allotted by AID for any given fiscal year is smaller than the programming figure provided in May of the preceding year, the difference will have to be made up from other money. This is reasonable, since the basic philosophy behind the programming system is that:

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* Projects are defined as major components of the program as described in the GSL budget, i.e. each headworks item and each downstream irrigation system, e.g. B, C and H.

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(1) The GSL will decide what it wants to achieve in the Mahaweli Development program during a given year, taking into account this loan and its overall financial situation, the relative priority accorded to the Mahaweli scheme, implementation capacity, and the status of work achieved on its component elements. (The Mission will have to satisfy itself that this GSL annual program is proper and reasonable); and

(2) The use of the loan-generated rupees is not intended to result in any increase in the level of Mahaweli investment for a given year over what has been authorized, but rather should be considered as a non-inflationary means of permitting the GSL to finance what it has planned and budgeted to do.

Inherent in the above concept is the fact that at the level of line items in the program documents, all resources (GSL and donors) are comingled. This eliminates the need for the MASL or its subsidiary agencies to set up any special set of accounts to trace A.I.D. allocated rupees through to their specific use. AID concerns will be amply met if the MASL accounts and GSL audits show that the amounts budgeted from all sources of financing for a given line item have been expended for that purpose and that the intended physical accomplishments have been achieved.

2. Reporting and Monitoring - The MASL will be required to submit quarterly reports through the Ministry of Finance and Planning to USAID showing:

(a) Expenditures of funds by line items identified in the annual program documents;

(b) Status of accomplishment towards physical implementation targets.

The physical implementation targets referred to above are those which the Mahaweli Authority fixes in relation to the line items in its annual budgets, e.g., numbers of kilometers of secondary road constructed, numbers of families resettled, numbers of schools built. These targets relate to the totality of the line item expenditures budgeted and not just to the A.I.D. rupee allocations. USAID will have discussed these physical targets with appropriate GSL officials in assessing the adequacy of proposed budget allocations for downstream activities. These targets will be recorded in the MASL's own planning documents, but not in the annual USAID/GSL program annexes.

Since the basic purpose of this sector support loan will be achieved if and when the GSL provides adequate amounts of money for downstream development activities in each year's Mahaweli budget, review of the MASL reports and clarification/investigation of any problems which may emerge from such reviews are the only formal monitoring of the use of the loan to be undertaken by the Mission. These reviews may be supplemented on an ad hoc basis by such spot checks in areas where the line item activities are located as can be arranged in the course of field trips taken for other purposes, but the activities will not be, and should not be, monitored as project-funded activities are. Rupee allocation program changes will be made by the GSL as necessary with USAID concurrence. In assessing the reasonableness of requested program changes, USAID will consider the revisions the MASL proposes to make in its physical implementation targets. As long as the GSL expends rupees for the activities agreed to in these annual program annexes, keeps USAID informed of implementation progress, and obtains USAID concurrence to modifications in annual agreed allocations, it will be in compliance with the conditions which AID attaches to the use of the sector support.

C. <u>Disbursement of AID Dollars</u>

AID will reimburse to the GSL dollars by means of the unrestricted special letters of credit (USLC) for expenditures of rupees made by the GSL according to the agreed annual program annex. Only expenditures made by the GSL after the signing of the loan agreement will be eligible for reimbursement. MASL will prepare and submit to the External Resources Department (ERD) of the Ministry of Finance and Planning the quarterly report described above. ERD will forward the quarterly report to USAID along with a request that AID have a specified U.S. bank open or amend a USLC on behalf of the Central Bank of Ceylon (beneficiary) for the dollar equivalent of the rupees expenditures shown in the quarterly report as being attributed to the AID loan. USAID will cable the request to AID/W where FM/BFD will instruct the U.S. bank accordingly. Interest will begin on the loan when the USLC is issued by the U.S. bank.

The Central Bank of Ceylon may instruct the U.S. bank to issue subsidiary letters of credit or otherwise make payments at sight to designated supplies of U.S. source purchases ordered after the USLC is opened. The USLC can be used to finance public or private sector transactions. Specific procedures for collection by GSL of rupees for USLC-financed purchases do not require AID approval. (State 068450, March 18, 1981).

IV. <u>CONDITIONS AND COVENANTS</u>

The only conditions in the loan agreement will be the usual legal opinion and authorized representatives. The only covenant will be the usual one concerning program evaluation. However, the model project loan agreement in Handbook 3 will have to be modified somewhat since the loan is not for project assistance but contains features of both program and project assistance. The Handbooks do not contain a model program assistance agreement. The agreement shall also include a provision that at least 25% of the total cost of any major project in the AMP which receives assistance from this loan shall be from non-U.S. sources.

27

Economic Analysis of the GSL Government Budget, Inflation, and the Effect of A.I.D. Local Cost Financing

1. Recent Trends in the Government Budget

In recent years, the GSL budget has been under increasing strain as expenditures which have been accelerating rapidly in response to the ambitious development program have been accompanied by only moderate increases in revenues. The table below presents the budget figures for 1979, estimates for 1980, and recently revised GSL projections for 1981.

The capital expenditure budget has been increasing very rapidly. 1978 represented a 143% increase over 1977, as compared to a 70% increase in recurrent expenditures. Starting from this higher base, capital expenditure increased by 36% in 1979 over 1978 to a new total of Rs.8,991 million (above $580 million). In 1980, it is expected to increase again by approximately 38% to a level of Rs.12,392 million (about $700 million). The initial budget estimates for 1981 projected a further increase (in current prices) of 25% to Rs.15,461 million, but the recently revised budget figures reduced this to Rs.12,739 (about $695 million) which is only slightly above the 1980 figure and less in real terms.

On the revenue side, there was a dramatic increase of 74% in 1978 over 1977, but this slowed down to 9% in 1979 over 1978 for a total of Rs.12,730 million (about $820 million). In 1980, the estimated increase over 1979 is only 3.6%, for a new total of Rs.13,194 million (about $740 million). The Minister of Finance's latest projections for 1981 (November 5, 1980) show a reversal of this trend and anticipate a 23% increase over 1980 to Rs.16,225 million (about $910 million). This might appear overly optimistic. The 1981 receipts, however, include some new taxes and a recuperation of funds advanced in 1980 to purchase wheat flour. Netting out these two elements, the increase over 1980 on the same tax base is only 14.6%. In a situation where inflation is running well over 20%, this may not be unreasonable.

Recurrent expenditures increased sharply by 70% in 1978. However, they increased by only 2% in 1979, and they are projected to increase by 26% in 1980 (almost 40% of the increase was a one time advance to purchase wheat flour). For 1981, a 3% decrease is programmed. If the wheat flour advance is netted out, 1981 represents a 4% increase over 1980.

SUMMARY BUDGET DATA 1979-81[1]

	(millions of rupees)		
	1979	1980 (Est.)	1981 (Rev.Projection)
Recurrent Expenditure	12,530	15,811	15,332
Revenue	12,730	13,194	16,225
Curre[illegible] Acct.Surplus/Deficit	+200	-2,617	+893
Capital Expenditure	8,991	12,392	12,739[2]
Overall Deficit	8,791	15,009	11,846
Financing of Deficit			
Domestic Sources	4,554	7,57[illegible]	3,750
External Loans & Grants	4,237	7,4	8,100

1 Source: Minister of Finance, Nov. 5, 1980 Budget Presentation
2 Includes loan repayments and sinking fund contributions of Rs.1,620 million.

The GSL uses a rolling, five-year development prog[illegible]m inst[illegible]ent. Its initial capital expenditure estimates were Rs.47 billion ([illegible].0 billion) for the 1979-83 period. The 1980-84 program called for an increase to $4.3 billion, on the basis of a reduced level of real investment. (The cost of fully executing the work included in the 1979-83 plan is now estimated at $6.75 billion, rather than $3.0 billion). As indicated above, the GSL plans to cut back even more on the pace of development spending. The 1981-85 investment plan continues the strategy whi h the Ministry of Finance followed in 1981; i.e. to maintain--at least in 1982, 83 and 84 -- the levels shown in current rupees for these years in the 1980-84 plan, with no significant upward adjustments for price increases and inflation except those which relate to donor financing and changes in the exchange rate. Thus the rate of real investment will be slowed down by a percentage equivalent to the rate of inflation. Even at this level of investment, and even if external financing at projected levels is available, continued budget deficits of substantial magnitude are anticipated.

The GSL beleives that any further slow down in the pace of investment would seriously compromise the objectives of the development program. Thus, the Government finds itself facing a trade-off, with a need for careful balancing between the extremes of inadequate levels of investment -- with all that implies in the way of social and economic development -- and excessive budgetary deficits with inflationary consequences.

2. The Government Budget and Inflation

Increased spending pressures resulting from the accelerated GSL public investment program have led to increasing budget deficits that have reached 43% of government expenditures in 1979 and an estimated 53% in 1980. Actual expenditures have substantially exceeded planned expenditures because of significant original underestimation of many costs, partially due to unanticipated inflation in critical areas like construction. Rather than reduce real levels of investments, line ministries responded by requesting and obtaining substantial supplemental budgetary allocations. The result has been that actual capital expenditures exceeded planned capital expenditures by 25% in 1979 and an estimated 51% in 1980.

The share of the Government budget deficit financed by domestic credit creation in 1979 was 52% and as estimated 51% in 1980. This increased domestic credit contributed o an increase in the money supply of about 29% in 1979. The mon / supply would have increased by more than 40% in 1980, except that the impact of increased domestic credit was offset by a $200 million decrease in international reserves that reduced the actual increase in the money supply in 1980 to 23%.

The increased level of domestic credit and resulting increase in the money supply led to IMF's suspension of its Extended Fund Facility (EFF) agreement with Sri Lanka in August, 1980. However, following the monetary reforms introduced by GSL in March, 1981 to control the domestic credit expansion, the EFF was resumed in June 1981 with a drawing of SDR 37.5 million. About SDR 113 million of the SDR 260 million negotiated in January, 1979 remain available for drawdown by GSL. In addition, the GSL also drew another SDR 25.3 million in June, 1981 from the Compensatory Fund Facility (CFF) which is an IMF credit facility extended to developing countries experiencing export shortfalls.

The major concern that arises because of the increased budget deficits, domestic credit, and money supply is the consequent pressure on inflation. Increased inflation will adversely affect the GSL's plans for the country's future economic growth and development. Government budget deficits tend to widen with inflation, which could lead to a vicious circle of deficits contributing to inflation which in turn contributes to increased deficits. Inflation also will tend to reduce the real levels of planned investments that can be achieve. It also may endanger the liberalized exchange rate and trade policy reforms the current Government has implemented, depending on how far the GSL is willing to let its currency depreciate. Finally, inflation could have serious distributional impacts, causing a deterioration in the living standards of low-income groups.

It is important to recognize, however, that deficit financing has not been the only, and perhaps not even the major, factor causing inflation in Sri Lanka. Price control (i.e., subsidy removal) on some key consumer items* has accounted for a significant share of price increases. For example, consumer prices increased by 43.3% from March, 1979 to March 1980, but by only 21.3% if the quantum jumps in decontrolled prices are netted out. Similarly, from September 1979 to September 1980, the inflation rate is reduced from 33% to 19% if the same netting out procedure is applied. The underlying inflation rate, therefore, is significantly less when these once-and-for-all quantum jumps in prices are excluded. The decontrol of energy-related items (e.g., petrol, electricity and transportation) has been directly related to the rapidly increasing price of imported oil.

Although the immediate direct impact of subsidy reductions is to increase prices, the indirect impact through the effect of such reductions on the government budget should lessen inflationary pressures since requirements for deficit financing should be reduced. This makes the high government budget deficits of 1979 and 1980 appear even more serious.

Another important factor contributing to inflation has been the sharp increase in construction costs reflecting increasing scarcities of raw materials, skilled workers, and construction capacity in relation to the expanded demands of the public sector investment program. Increased reliance on imports have further worsened inflationary pressures since the prices of some imported construction materials are substantially above domestic prices. It is unlikely that these inflationary pressures in the construction sector will ease.

Lastly, Sri Lanka's terms of trade have deteriorated as the prices of essential imports have risen dramatically, while the prices of Sri Lanka's traditional export commodities have fallen.

In summary, inflation until now has been mostly caused by price decontrol, worsening external terms of trade, and increasing domestic resource shortages, particularly in the construction industry. These factors are either uncontrolled or, in the case of price decontrol, desirable from an overall economic policy viewpoint. The impact of increasing levels of domestic credit on inflationary increases in the

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* These items include rice, flour, sugar, kerosene, milk powder, fresh coconuts, coconut oil, electricity, petrol and transportation.

money supply has been largely offset by declining levels of international reserves. The currently very low level of international reserves, however, will not allow such an offset in 1981.

3. Implications for GSL Economic Policy

The GSL responded to the worsening fiscal situation by announcing in November 1980, major cuts in 1981 planned capital expenditures, and some minor revenue increases in order to reduce the deficit to more manageable proportions. As a result, the government deficit as a share of total expenditures will decrease from 53% in 1980 to 32% in 1981.

The 1981 budgets for most major ministries were cut by 25%, including the Mahaweli program. Although these severe budget cuts demonstrate courage and an apparent commitment by the GSL to reverse the deteriorating fiscal situation, the need for quick action led to the levels and allocation of cuts being somewhat arbitrary. Great care will have to be taken in implementing these directives to mitigate their adverse effects. For example, to the extent possible cuts should be avoided which would result in delays or cancellations of foreign aid disbursements. This would be self-defeating to the extent that expenditure cuts are offset by reductions in foreign aid.

Additional subsidy reductions or removals would also serve to reduce the pressure on the government budget. Subsidies on items like fertilizer and food still represent significant drains on the government budget. Adjusting subsidies that affect the living standards of the low-income groups, however, must be accomplished with great care.

The GSL is now facing the classic economic trade-off between increased output and employment on the one hand and inflation on the other. Many signs are pointing to the fact that the public investment program initiated in 1977 has become too ambitious in relation to available resources, even considering the large amount of foreign aid commitments that have been made. If the revised 1981 budget is exceeded in a way similar to the 1980 excesses, the results could be disastrous for the economy of Sri Lanka. International reserves are too low to be drawn down any further as an offset to increased domestic credit creation, and a 40 to 50% increase in the money supply on top of an already heated economy could easily push Sri Lanka into a hyper-inflation situation.

It is also important that in revising its investment program the GSL provide a balance between the long-gestation lead projects and projects with shorter-term productive outputs. Too great a share of government spending that does not result in real output in the short-run can also lead to inflationary pressures. The GSL must also try to balance private sector needs with public sector needs.

4. <u>Economic Rationale of A.I.D. Local Currency Financing</u>

The basic economic rationale of the sector support to be provided under the proposed loan (i.e. the generation and programming of rupees for the Mahaweli program) is that it provides the GSL with a non-inflationary mechanism of obtaining rupees to cover projected financing gaps in the Mahaweli program within revised overall GSL budgetary ceilings. The purpose is not to allow expenditures to exceed the revised ceilings once they are set.

The rupees to be generated by the unrestricted special letters of credit represent additonal budgetary resources for the GSL and thereby reduce the amount of domestic credit that GSL would otherwise have had to use to finance a given level of spending. This will be approximately 11% of the estimated domestic borrowing that will be required to cover the planned deficit in 1981.

The IMF Extended Fund Facility included a condition that imposed an overall ceiling on domestic credit, but the suspension of the EFF in August, 1980 primarily because this ceiling was exceeded, left no upper limit except that imposed by the fiscal discipline of the GSL. In view of the recent strong GSL budget actions, the IMF resume its EFF in June 1981 with a new domestic credit ceiling condition. The predominantly pragmatic economic policies of the current GSL, with the exception of the recent expenditure excesses, plus the substantial 1981 budget cuts announced in November, are good reasons to trust that fiscal discipline will be restored.

In summary, A.I.D. local currency financing under the proposed loan will allow the GSL to finance its expenditures for 1981-83 with a lower level of domestic credit. In a time of increasing budget stringency and inflationary pressures, non-inflationary local cost sector support for such an important program is an appropriate use of development assistance. If this form of assistance were matched by other donors, a significant contribution could be made to the GSL's efforts to stabilize its fiscal and monetary situation.

33

ANNEX 2

Balance of Payments Analysis

1. Current Situation and Projections

Sri Lanka's balance of payments deteriorated sharply in 1980. Table I shows that the current account deficit more than tripled from $228 million in 1979 to $644 million in 1980. International reserves were depleted by $220 million during 1980, and at the end 1980 net international reserves reduced to a level of $406 million, equal only to about two months worth of imports.

This deterioration in the balance of payment continues the trend that began last year when the deficit almost doubled from 1978 to 1979, while imports increased by 42%. Imports in 1980 have increased by 40% over 1979 (See Table II).

Large increases in imports have been the major cause of the deteriorating current account balance. About 75% of the increase in imports in 1980 has been intermediate and investment goods, mostly due to the increased volume and cost of imports generated by the public sector investment program and primarily financed by foreign aid. The remaining 25% was in consumer goods. Intermediate and investment goods are expected to increase their share of total imports from 65% in 1979 to 70% in 1980 and 71% in 1981.

Another factor increasing the deficit has been the worsening terms of trade that Sri Lanka has been experiencing. During 1978-84, the prices of merchandise imports are expected to increase at annual average of 12% while export prices are anticipated to increase by only 9% annually. These projections imply a deterioration of Sri Lanka's terms of trade by almost 13% between 1979 and 1984.

Although imports are expected to grow at the much less rapid rate of 11% in 1981, and exports to rebound to an 11% growth rate, the deficit will still increase by 9% to a level of $833 million. With deficits at such unprecedented high levels, it is necessary to assess very carefully deficit financing prospects and implications for maintaining current investment plans.

Table III estimates the external financing gaps for 1980 and 1981. In 1980 the gap was largely financed by drawing down international reserves by $220 million, which will not be possible in 1981 as net reserves are now at a precariously low level. There was also a substantial increase in the use of short-term trade credits in 1980, especially to finance petroleum imports. Continued heavy use of trade credits would begin to have an adverse impact on Sri Lanka's credit worthiness and debt service situation. Sri Lanka was able to draw a $50 million Eurodollar loan in 1980, which will also worsen the debt service picture. The debt service ratio, however, should remain below 15% over the next five years.

Although the financing gap in 1981 is not as large as 1980, mostly due to increased aid disbursement arising from higher foreign assistance commitments, Sri Lanka will not have the cushion of reserves that existed in 1980. The resumption of the IMF Extended Fund Facility, which amounts to about SDR 150 million for Sri Lanka in 1981, appears to be the most likely way to avoid excessive reliance on short-term trade credits.

Contributing to the worsening balance of payments situation has been the disappointing performance of exports. The 40% increase in the volume of imports in 1980 was accompanied by only a 9% increase in export receipts. Most disappointing has been the performance of plantation crop exports which increased only by about 10% in 1980, causing their share in total exports to decline from 65% in 1979 to 58%. This poor performance was caused both by drought weather conditions and cumulative effects of GSL policies that have tended to discourage increased plantation crop production. The GSL is now taking steps to reverse this trend.

The performance of minor agricultural exports and industrial exports was encouraging in 1980, growing at 44% and 32% respectively. Petroleum product exports increased by 32% in 1980 mainly because of higher prices and now account for about 50% of industrial exports. Garment and textile exports grew at 56% in 1980 and represent 35% of industrial exports.

The projection in Table II that exports will rebound in 1981 to an 11% growth rate may be optimistic. It assumes favorable weather conditions and adequate producer incentives. To the extent that these conditions do not hold, the balance of payments situation could be significantly worse than projected.

The import projections may also be optimistic. Petroleum imports, after more than doubling in 1980, are projected to increase by only 10% in 1981. This is based on the assumption that subsidy removals and conservation measures will succeed in keeping the volume of petroleum imports constant in 1981 (15 million barrels). The price of oil is projected to increase from $32/barrel in 1980 to $36/barrel in 1981. Holding "other consumer" imports steady at $325 million after a 17% increase in 1980 may also be difficult.

Projecting Sri Lanka's balance of payments even through 1981, therefore, requires making many assumptions about quite uncertain events. Projecting past 1981 through 1985 approaches a star-gazing exercise. It is not unreasonable, however, to speculate on the range of the current account deficit under varying circumstances over the next five years.

The World Bank's 1980 economic report on Sri Lanka provided a range of the annual average deficit over 1980-84 of between $712 million (official GSL estimate) and $956 million (IBRD adjustments

35

with less favorable assumptions). The main assumptions that were adjusted by the IBRD regarded the behavior of exports, private remittances, and factor service payments.

The events of 1980, however, have shown that even the IBRD projections with less favorable assumptions were optimistic. For example, the IBRD's adjusted deficit figures for 1980 and 1981 of $620 million and $725 million respectively are significantly lower than our more recent estimates of $644 million and $833 million. With greater than expected import pressures and poorer export performance, the average annual current account deficit over 1981-85 could be between $1.2 and $1.5 billion. The greater the current account deficit tends to increase over this period, the more likely it is that further cutbacks in growth and investment will have to occur and that import controls might be reimposed. The balance of payments situation, therefore, could threaten to undermine the basic development strategy of the current government.

2. Implications for GSL Economic Policy

The trade and exchange rate policies that the GSL has adopted since 1977 have in many ways been favorable to an improved balance of payment situation. The devaluation and unification of the exchange rate system replaced an inefficient system of import controls and provided increased incentives to exports, particularly industrial exporters. The GSL policy of letting the exchange rate float has maintained these favorable incentives. The reduction or elimination of subsidies on many imported consumer goods has discouraged excessive imports of these commodities, and has succeeded in achieving significant reductions in certain area. The GSL has also embarked on a strong export promotion strategy, establishing special incentives for exporters and a Free Trade Zone program to attract processing and re-export activities.

Despite these favorable policies, however, several GSL policies have contributed to the recent deterioration in the balance of trade. Although the poor performance in plantation crop exports in 1980 was strongly influenced by poor weather conditions and sagging prices, there evidence that GSL policies also have discriminated against these producers and eroded incentive to increase production. Export taxation on coconuts, rubber and tea has been excessive, and has eroded profit margins. With these crops representing between 55% and 65% of total export earnings, Sri Lanka cannot afford many years like 1980 when plantation crop export receipts decreased by 14%.

Perhaps the most important GSL economic policy decision affecting the balance of payments is the level of economic growth and investment that it decides to maintain. High levels of investment imply high levels of imports, and to the extent that these imports are not covered by the country's own foreign exchange resources or foreign aid, large financing gaps such as occurred in 1980 will

36

continue. The GSL must carefully plan its investment programs so that desired growth rates are balanced with the maintenance of external financing gaps at sustainable levels.

The GSL has done an excellent job of lining up foreign donor support for its investment program. Over half of the current account deficit is covered by foreign aid flows. High levels of donor support can be expected to continue barring any unforeseen circumstances.

The GSL should also ensure that the managed floating exchange rate be allowed to adjust adequately to domestic vs. world inflation rates. Although the GSL seems to have achieved this so far, if high inflation rates continue, the maintenance of a realistic exchange rate may become endangered. In other words, the GSL may resist a continual depreciation of the rupee at the 17% annual rate of this past year. The alternative, however, is a resumption of import restrictions and disincentives to exporters.

3. Balance of Payments Role of Proposed Assistance

Intermediate and investment goods represented 75% of the increase in total imports in 1980, and they will continue to dominate the import needs of Sri Lanka over the medium-term. These imports will represent about 72% of Sri Lanka's total imports in 1981. This relatively high share of development imports presents a sound framework within which to transfer foreign exchange resources.

The addition of $18.8 million in 1981 to Sri Lanka's foreign exchange resources is not large in relation to total foreign exchange flows, but when compared to the projected 1981 $272 million unfinanced gap (see Table III) it is not insignificant.

37

TABLE I

Balance of Payments
(millions US$)

	1979	1980 (Provisional)	1981 (Projected)
1. GOODS	-467	-969	-1220
Exports	979	1063	1135
Imports	-1446	-2032	-2335
2. SERVICES	48	52	63
Receipts	192	277	299
Payments	-144	-225	-236
3. TOTAL GOODS AND SERVICES	-419	-917	-1157
4. PLUS TRANSFERS	191	273	324
Private	48	136	157
Official	143	137	167
5. CURRENT ACCOUNT DEFICIT (3 + 4)	-228	-644	-833
6. NON-MONETARY CAPITAL	212	447	418
Private	56	249	181
Public	156	198	237
7. ERRORS AND OMISSIONS	46	-39	-46
8. SDR ALLOCATIONS	16	16	16
9. OVERALL BALANCE (5 + 6 + 7 + 8)	46	220	-353

TABLE II

Major Exports and Imports

(Million US$)

	1979	1980 (EST)	1981 (EST)
EXPORTS	979	1063	1155
Tea	366	373	373
Rubber	160	156	189
Coconut	108	45	64
Minor Agric. Crops	54	80	98
Industrial Products	239	339	346
Textiles/Garments	(71)	(108)	(111)
Petroleum	(124)	(188)	(176)
Other	(44)	(43)	(59)
Gems	31	41	46
Others	21	29	39
IMPORTS	1446	2032	2223
Rice	57	45	20
Flour/Wheat	108	154	97
Sugar	59	115	174
Petroleum	250	486	603
Fertilizer	43	80	73
Other Consumer Goods	277	328	325
Other Intermediate Goods	223	324	363
Investment Goods	350	492	563
Other	79	8	5

TABLE III

External Financing Gap
(millions US$)

		1980	1981
A.	CURRENT ACCOUNT DEFICIT	644	833
B.	Plus Debt Repayments	62	66
C.	Gross Foreign Exchange Requirements (A+B)	706	899
D.	Less External Sources of Foreign Exchange	447	627
	Net Direct Foreign Investment	45	70
	Loan and Grants	386	541
	SDR Allocations	16	16
E.	Unfinanced Gap (C-D)	259	272

MAHAWELI PROGRAM: BACKGROUND AND FINANCING REQUIREMENTS, 1981-85

BACKGROUND*

Mahaweli Ganga Development Program - Status Statement III

I. INTRODUCTION

The Mahaweli Ganga Development Program

1.01 The basic objective underlying the Mahaweli Ganga Development Program stems from the need to overcome three major problems which Sri Lanka faces: (i) unemployment, (ii) excessive imports of food and other agricultural products, and (iii) a shortage of power for industrial development and rural electrification. During the construction phase, the Program will provide large-scale employment benefits. After construction, about 225,000 farm families will be settled on the new land, and over a million people will be gainfully employed in agricultural and allied pursuits. The output of these people will significantly reduce the need to import rice, wheat flour, and other food items, for which the foreign exchange bill was about US$3.8 M in 1979, or about 30% of the export earnings for the year. At full development, Sri Lanka's need for hydropower will be covered for the remainder of the century.

1.02 The Program is based on a Master Plan prepared jointly by a UNDP/FAO team and Sri Lankan engineers in 1965-68 (see Map). The Plan envisaged development of about 365,000 ha of irrigable land in the dry zone, as well as about 500 MW of hydropower. It was divided into three phases, each including several projects, for stepwise implementation over a 30-year period. With World Bank financial assistance, the initial construction of the Program began in 1970 on transbasin diversion headworks at Polgolla on the Mahaweli Ganga and at Bowatenna on the Amban Ganga, including a 40 MW hydropower plant at Polgolla (a second 40 MW hydropower plant at Bowatenna, assisted by the Asian Development Bank, is currently under construction). The project completed in 1978 provides an improved water supply to about 53,000 ha of existing irrigated land and a full irrigation supply to about 40,000 ha of new land. Under a second IDA credit, in collaboration with Canada, the EEC, the Netherlands, UK, and US, work is underway on the development of irrigation systems and the construction of new villages and towns on about 29,000 ha of the new land (the Government undertook the development of the remaining 11,000 ha with its own resources), land development, settlement, and on improving agricultural extension and support services.

The Acceleration of the Mahaweli Program

1.03 Late in 1977, the Government realized that, at the current rate of construction and population growth, the Program would not have much impact on the country's economy in terms of meeting the unemployment problem and the serious food and power shortages, and that it would have to be accelerated. An Implementation Strategy Study was carried out by the Netherlands-financed consultants (NEDECO) to: (i) review and re-evaluate the UNDP/FAO Master Plan and each of the separate projects; (ii) examine the implications of various

42

alternative phasings of the feasible projects; and (iii) recommend a specific action plan taking into account technical, financial, economic, institutional, and manpower constraints.

1.04 After a review of available financial resources, construction capabilities and trained technical personnel, the Government decided to accelerate the construction of five major projects, comprising five dams and hydropower plants with an installed capacity of about 600 MW, and development of about 117,000 ha of new lands. During the early months of 1978, the Government approached several prospective donor countries for assistance in the preparation of the five projects. Expressions of interest were received from the following: (i) Kotmale Project - Sweden; (ii) Victoria Project - UK; (iii) Randenigala Project - Germany; and (iv) Maduru Oya Project - Canada. Japan agreed to finance a feasibility study of the Moragahakanda Project. Other possible external assistance included an expression of interest by the Government of Canada to finance feasibility studies of some of the other projects in the Program. The US expressed interest in providing finance for downstream development (the irrigation system) of the Maduru Oya Project (System B). The US also undertook to finance an in-depth study of the impact of the Accelerated Program on the environment. The Asian Development Bank provided a grant of US$98,000 to assist in the planning of roads in the Mahaweli area, and the EEC has expressed interest in an involvement in the development of System C, as has IDA. Under a Special Action Credit, the EEC is financing consultancy services for the detailed design and engineering of the irrigation infrastructure in System C. (see Table on page 23 for pledges).

An Overview of Progress to Date

1.05 The first two years since the decision of the Government to accelerate the implementation of the Mahaweli Program was devoted to the carrying out of the necessary mapping and investigations and the preparation of feasibility studies of projects under the Accelerated Program 1/, as well as the preparation of their final plans, detailed designs and tender documents. Aerial photography (black and white and infrared under 1:20,000 scale) was completed for the entire Accelerated Program area, as well as the catchment areas of the Mahaweli Ganga. Maps on 1:5,000 scale with one meter contours were completed for almost all of the downstream areas of Systems A, B, C, and D. Soil survey and land classifications were completed for the areas under Systems B, C, and D and are ongoing in System A. The feasibility reports for Maduru Oya Dam and System B (by ACRES of Canada, financed by the Government of Sri Lanka's own resources) and for Victoria Dam and System C (by Hunting Technical Services, Sir Alexander Gibbs and Partners, and Preece, Cardew and Rider, engaged under UK bilateral assistance) have been completed. The feasibility report for the Randenigala and Rantembe Projects (by Salzgitter Consult, Agar-und-Hydrotechnik and Electrowatt Engineering Services, financed by the Federal Republic of Germany) has been completed and the consultants are now engaged in the preparation of final plans and designs, cost estimates and tender documents for completion by the end of 1980. The feasibility report for the Moragahakanda Project by Japanese consultants (Japan Engineering Consultants and Nippon Koei, engaged with bilateral assistance from Japan) has also been completed.

1/ Except for Kotmale Project for which a feasibility study (by WAPCOS of India) was completed with technical assistance from India. The report was submitted to the Government of Sri Lanka in January 1973.

43 .

1.06 Final plans, detailed designs, cost estimates and tender documents for Victoria Dam and power plant and for Maduru Oya Dam were completed. Contracts for the construction of the Victoria Dam, tunnel, and associated structures have been awarded to a joint venture of two British contractors (Balfour Beatty & Co., and Edmund Nuttal & Co). Tenders for the powerhouse and electro-mechanical equipment have been called. The contract for Maduru Oya Dam and link tunnel has been awarded to a consortium of four Canadian contractors (Foundation Co. of Canada, Atlas-Gest International, Fitz Patrick Construction, and Vanin Construction). Tenders for electro-mechanical equipment have been called and awards will be made shortly. A contract for the initial work, the tunnel and the powerhouse for the Kotmale Project has been entered into with a Swedish contractor (SKANSKA) and the contract for the dam will be entered into with the same contractor.

1.07 Early in 1980, in the context of the annual review of its rolling Medium-Term Public Investment Program, the Government took stock of all its capital investment proposals for the period 1980-84 as against a careful reassessment of available domestic and foreign resources. Faced with rapid escalation in costs and consequent problems in financing, the Government made a conscious attempt to scale down its lead investment projects, including the Mahaweli Program. Accordingly, the proposed investment in the Program was scaled down from Rs 24 B (US$1.5 B equivalent) to Rs 18.2 B (US$1.2 B equivalent) so as to make provision for construction to begin on three of the major dams, namely, Kotmale, Victoria, and Maduru Oya (with a possibility of work beginning on Randenigala/Rantembe by 1983) and downstream development covering 49,000 ha. Even with these bold measures, however, a serious issue remains relating to the financing of the Program.

44

II. STATUS OF MAHAWELI PROGRAM

A. Headworks

Kotmale Project

3.03 The Kotmale Project, situated on the Kotmale Oya, a tributary of the Mahaweli Ganga, is mainly concerned with power generation. It will regulate the flow of the Mahaweli Ganga above Polgolla, and add irrigation and power for downstream projects. The basic elements of the scheme are a dam on the Kotmale Oya, a tunnel system leading to an underground powerhouse and an outfall discharged into the Mahaweli Ganga.

3.04 Preliminary studies of the project were carried out with USAID assistance during 1958-61, and subsequently a feasibility study was provided by Water and Power Development Consultancy Services (India Ltd.) during 1973-78. Although further investigations are proceeding at the dam site to finalize the designs, the project, as presently conceived, consists of a rockfill dam 115 m high and 600 m long with a gross storage capacity of 363 M cu m. The shute spillway, located on the right abutment of the dam and controlled by three 14x14 m radial gates, will be capable of passing the probable maximum flood of 5,400 cu m/sec. The water impounded in the reservoir will be conveyed through a tunnel to an underground hydro-powerhouse about nine km downstream. The tail water will be discharged by tunnel into the Mahaweli Ganga. The project is estimated to have an annual output of 513 GWh with an installed capacity of 200 MW.

3.05 The project is expected to cost Rs 5,000 M at 1979 prices (US$320 M), of which 80% (Rs 4,000 M or US$256 M) will be in foreign exchange. It is being partly financed through Swedish import support over the next five years totalling SKr 630 M (US$170 M equivalent). A negotiated contract in the amount of Rs 650 M has been entered into with a Swedish contractor (SKANSKA) for the construction of access roads, construction camp, and other site preparation and preliminary works. A second contract in the amount of Rs 1,200 M has been entered into with the same contractor for the construction of the underground works, including the tunnel, powerhouse, and related works. The contract for the dam will be awarded after the designs and cost estimates are finalized. The completion date for the first of three power units is scheduled for end-1983.

Victoria Project

3.06 The Victoria Project, located between the confluence of the Mahaweli Ganga and Hulu Ganga and the Victoria Rapids, will provide 210 MW of power generation capacity and irrigation water to serve about 53,000 ha of lands in the Mahaweli and Maduru Oya Basins. Various alternative combinations of dam heights for the Victoria Project and the Randenigala/Rantembe Projects (located 21-24 km downstream from Victoria) were studied for the purposes of optimizing power and irrigation benefits. These studies, carried out by Netherlands-financed consultants (NEDECO) and also independently by UK-financed consultants (Hunting Technical Services, Sir Alexander Gibb and Partners, and Preece, Cardew and Rider), indicated that a high Victoria Dam and a low Randenigala Dam would be the best combination from the technical and economic points of view.

45

3.07 The Victoria Dam will be a double curvature arch type about 118 m high and 507 m long at the crest. At a top level of 478 m above mean sea level, the surface area of the reservoir will be 24.2 sq km with a gross storage capacity of 730 M cu m and a live storage of 690 M cu m. The spillway is designed to discharge a maximum flood of 8,200 cu m/sec. Low level sluices will be provided to permit routine or emergency drawdown of the reservoir. Eight radial gates 8 m igh and 12.5 m wide will be provided for the spillway and the two low level sluices will each have a diameter of 4.1 m.

3.08 Three power units of 70 MW each will be installed, capable of generating 780 GWh of energy per annum. There is also provision for the installation of three additional units of 70 MW each for peaking purposes at a later stage. The tunnel will be 6.2 m in diameter and 4,900 m long, mostly concrete lined. The total length of the steel-lined tunnel section and the penstock section will be 1,250 m The powerhouse will be situated at the 232 m level and will discharge directly into the proposed Randenigala Reservoir.

3.09 The cost of the headworks (dam, tunnel, powerhouse, electro-mechanical equipment, and related works) is estimated at about Rs 4,500 M at 1979 prices (US$288 M equivalent), of which about Rs 3,400 M (US$218 M equivalent) or 76% of project cost will be in foreign exchange. The UK has committed £ 100 M (US$220 M equivalent) for project construction. A construction contract has been awarded to a joint-venture of UK firms (Balfour Beatty and Company, and Edmund Nuttall and Company). Mobilization of the contractor is scheduled for this summer, with project completion by end-1984.

Randenigala and Rantembe Projects

3.10 The Randenigala and Rantembe Projects, situated on the Mahaweli Ganga 21 km and 24 km, respectively, downstream from the Victoria Project, will provide about 175 MW of power generation capacity and irrigation water to serve about 36,000 ha. The NEDECO study showed that the irrigation water from the Randenigala Dam (then proposed as a high dam without the Rantembe Project) is not needed in the Mahaweli or Maduru Oya Basins and thus is available to irrigate land elsewhere in the North Central River Basins (NCRB) or the Northwest or Southeast Dry Zones. Under the IDA-financed Mahaweli Ganga Technical Assistance Credit approved in January 1980, a transbasin diversion study will be carried out to investigate alternative plans for conveying and utilizing this surplus water.

3.11 Feasibility studies were carried out during April-December 1979 by a joint venture of German-Swiss consultancy firms (Salzgitter Consult, Agar-Und Hydrotechnik, and Electrowatt Engineering Services), financed by the Federal Republic of Germany under a concessionary loan in the amount of DM 4.0 M. The consultants studied various alternative designs, including a high Randenigala Dam and a Randenigala and Rantembe combination of dams. The study indicated that a high Randenigala Dam would cost much more than the lower Randenigala/Rantembe combination. In addition, the geological conditions at the proposed high Randenigala Dam site were found to be unfavorable. Moreover, a high Randenigala Dam would submerge the future lower Uma Oya hydropower dam site indicated in the UNDP/FAO Master Plan. In these circumstances, the Randenigala/Rantembe combination was found to be more attractive from both the technical and economic standpoints.

3.12 Geological investigations of the Randenigala and Rantembe sites indicate favorable rock conditions suitable for the proposed construction. The Randenigala Dam is sited in a narrow river section of the Mahaweli Ganga approximately 3 km upstream of its confluence with the Uma Oya. The length of the dam will be 500 m measured along the crest and the maximum height of the dam will be 90 m. The dam will be a rockfill type with a central impervious core. The materials to be excavated from the diversion tunnel and the spillway will be used as rockfill. The spillway is designed to pass the probable maximum flood of 8,100 cu m/sec with all three gates open. The gates are of the radial type 15 m high and 16.7 m wide. Two diversion tunnels at the right bank will be provided for river diversion during construction. One of these tunnels will be used as a bottom and irrigation outlet. The intake tower and the powerhouse are located on the left bank. The installed capacity of the powerhouse will be 126 MW (2 units of 63 MW each), and the average energy output will be about 525 GWh including a firm energy output of 366 GWh.

3.13 The Rantembe Dam is situated immediately downstream of the confluence of the Uma Oya with the Mahaweli Ganga. The dam will be a concrete gravity type with a crest length of 415 m and a height of 44 m. The spillway is designed to pass the probable maximum flood of 10,235 cu m/sec with all four gates open. The gates will be 16.4 m high and 16 m wide. The power station will be located on the left river bank. The intake works, penstock, and powerhouse are integrated into two blocks of the dam. The powerhouse will have an installed capacity of 49 MW, with a firm energy output of 158 GWh and an average energy output of 251 GWh per year.

3.14 The feasibility report gives the estimated costs (1979) of the Randenigala and Rantembe Projects (dams, powerhouses, and electro/mechanical equipment) at Rs 2,400 M (US$154 M equivalent) and Rs 1,350 M (US$86 M equivalent), respectively. At present, the German-Swiss joint venture is proceeding with the preparation of the detailed plans, designs, estimates, and tender documents to be finalized by end 1980 for Randenigala and by March 1981 for Rantembe. The Government of the Federal Republic of Germany has allocated an amount of DM 400 M (US$230 M equivalent) for the construction of the projects.

Maduru Oya Project

3.15 The Maduru Oya Project, situated in the Maduru Oya catchment east of the Mahaweli Basin, will provide about 7.2 MW of power generation capacity and will serve an irrigation area (System B) estimated to amount to about 37,400 ha (net) of new land and 3,750 ha of existing land under the Pimburuthawa and Vakerneri schemes. As the supply from the Maduru Oya is inadequate to serve the whole of this area, it will, therefore, be supplemented with water from the Mahaweli Ganga via the Right Bank Canal and the 6.6 km Ratkinda-Maduru Oya link tunnel. The Maduru Oya has its sources in the Uva hills lying in the southeastern sector of the island and drains an area of about 1,560 sq km. The average rainfall within the project area is about 1,700 mm and is concentrated mainly in the northeastern monsoon season from October-January.

3.16 Geological investigations by core drilling and trenching were carried out at the dam site and indicated suitable conditions for construction of a concrete or rockfill dam. The design of the rockfill dam was prepared by the

41

Central Engineering Consultancy Bureau with the assistance of the French consultants (SOGREAH) engaged with UNDP financing and with the World Bank acting as executing agency. The design of the dam was reviewed at several stages by an Engineering Review Board appointed by CIDA in which the World Bank also participated. The Board also reviewed the tender documents and the specifications and drawings for the dam and the link tunnel.

3.17 The dam will have a maximum height of 40 m and a length along the crest of 1,008 m. A central core rockfill protected by double layers of inclined filters is proposed. The upstream shell of the dam will be 1.8 horizontal and 1.0 vertical slope, while the downstream shell will have a slope of 1.5 horizontal and 1.0 vertical. A 150 m chute free flow spillway provided on the left bank saddle is capable of discharging 1,600 cu m/sec. The right bank irrigation outlet will have a capacity of 35.4 cu m/sec, while the left bank irrigation outlet will have a capacity of 49.5 cu m/sec. Turbines will be provided at both outlets while provision has also been made for irrigation bypass outlets. One turbine unit will be provided on the right bank while the left bank will have two similar units. Each turbine will have a maximum capacity of 2.4 MW operating under a rated net head of 13 m. The turbines will be of the Kaplan-type.

3.18 A contract for the construction of the headworks (dam, outlet works, generating facilities, and the link tunnel) has been awarded to a joint venture of Canadian firms (Foundation Co. of Canada, Allas-Gest International, Fitz Patrick Construction, and Vanin Construction) at a contract price of Rs 1,338 M (US$86 M equivalent). Canada has agreed to contribute up to Cdn $76 M (US$65 M equivalent) in the form of a concessionary loan for the construction of these works. It has also agreed to provide Cdn $7 M (US$6 M equivalent) as a grant to cover engineering services and construction supervision to be provided by a Canadian consulting firm (Crippen International), which began work in March 1980. The Government of Sri Lanka will provide about Rs 600 M (US$37.5 M equivalent) toward the cost of the civil works and US$5-6 M to cover the electro-mechanical equipment, bringing the total project cost to Rs. 1,725 M (US$110 M equivalent). Site preparation is nearly complete and mobilization of the contractor is expected in about July 1980. Project completion is scheduled for early 1983.

Moragahakanda Project

3.19 The Moragahakanda Project, situated 1.6 km upstream of the Elahera Anicut on the Amban Ganga, a tributary of the Mahaweli Ganga, will provide about 26 MW of power generation capacity and, as in the case of the Randenigala Dam, irrigation water to serve about 20,000 ha in the North Central River Basins or elsewhere in the Dry Zone. The project consists of a main dam and two saddle dams and has a storage capacity of 686 M cu m. The main dam across the Amban Ganga will be a rockfill dam with a central core 72 m high and 490 m long along the crest. The first saddle dam will be of concrete gravity type 62 m in height and 396 m in crest length. The second saddle dam will be of the central core rockfill type 42 m in height and 490 m long. The spillway is capable of discharging 8,400 cu m/sec. The powerhouse is located immediately downstream of the first saddle dam on the left bank and will have an installed capacity of 26 MW and an annual energy output of 145 GWh. The powerhouse is designed for the installation of another 26 MW at a future date.

3.20 The project is expected to cost about Rs 1,720 M at 1979 prices (US$110 M equivalent), of which about Rs 1,360 M (US$87 M equivalent), or 79% of project cost, will be foreign exchange. A Consortium of Japanese Consultants (Japan Engineering Consultants and Nippon Koei Co.), financed by the Japan International Co-operation Agency (JICA), completed its Feasibility Report and submitted it to the Government of Sri Lanka in October 1979. The Government intends to delay decision on final plan, detailed designs, and tender documents until the transbasin diversion study is carried out under the IDA-financed Mahaweli Ganga Technical Assistance Project (paragraph 3.10).

B. Downstream Development

Right Bank Canal Complex

Minipe Anicut

3.21 The new Minipe Anicut will be located about 500 ft downstream of the existing anicut which is now serving the Minipe Yoda Ela (the Left Bank Canal) which irrigates 6,650 ha in the Minipe scheme. The lower site of the new Minipe Anicut will provide better conditions both for the diversion structure as well as the first reach of the Right Bank Canal, which is located in difficult terrain with steep slopes. The new anicut will be a concrete structure of ogee section 210 m long and will be equipped with steel gates. The structure will also have scour sluices, head sluices, and silt ejectors installed with hinged leaf-type gates.

Right Bank Canal

3.22 The Right Bank Canal will carry water diverted from the Mahaweli Ganga at Minipe (together with the inflow of a number of Right Bank tributaries such as Loggal Oya, Heppola Oya and Diyabana Oya) from the Minipe Anicut to Ulhitiya Reservoir. The canal will be about 22.4 km long and have a discharge capacity of 63.7 cu m/sec. The canal will feed the Ulhitiya and Ratkinda Reservoirs, which will supply supplemental water for the irrigation of both Systems B and C, thus increasing the total irrigated area in both systems to 70,000 ha.

Ulhitiya-Ratkinda Reservoirs

3.23 The combined catchment area of the Ulhitiya Oya and Ratkinda Oya is 310 sq km. The length of the Ulhitiya Oya dam will be 4.8 km and that of Ratkinda will be 1.2 km. The maximum dam height for both Ulhitiya and Ratkinda will be 25 m. The total storage capacity will be 146 cu m. A link canal 1 km long will connect the Ulhitiya Reservoir to the Ratkinda Reservoir. The tunnel which will feed Maduru Oya Reservoir will be located on the eastern end of the Ratkinda Oya Reservoir. Main canals from both Ulhitiya and Ratkinda Reservoirs will convey water for irrigation to System C. A summary of the cost estimates of the project components at end-1979 prices are as follows:

Project Component	Estimated Cost (Rs M)
Minipe Anicut	15
Right Bank Canal	1,280
Ulhitiya dam	100
Ratkinda dam	75

3.24 The construction of the Minipe Anicut and the first 4.7 km of the Right Bank Canal has been entrusted to the State Development & Construction Corporation, an established Government Board. Initial construction work has commenced. The Ulhitiya Oya Dam has been entrusted to the River Valleys Development Board, another established Government Board. They have already done a considerable quantity of work on the left bank of the dam. Construction of the Badulu Oya Tunnel and the Ratkinda Oya Dam has been undertaken on contract by Ceylon Development Engineers, Ltd., a local private sector construction company. The contractor has already mobilized and commenced construction both on the tunnel as well as the dam. The balance of the Right Bank Canal and structures are expected to be financed by IDA. International tenders have been called for this work and the bids will close on June 10, 1980. It is hoped to complete the canal and associated structures by early 1983.

System C

3.25 The System C on the Right Bank of the Mahaweli Ganga will cover a net area of about 21,000 ha (net) falling within the command of the Right Bank Canal Complex. Most of the northern half of the area is covered with jungle with virtually no inhabitants. The southern half is partially developed and has about 3,500 ha under irrigated paddy, with water supplied from ancient tanks.

3.26 The soils in System C consist essentially of two types — the well-drained upland reddish-brown earths (RBE) and the poorly drained low humic gleys (LHG) in the valley bottoms. Between these types are intermediate, imperfectly drained soils. The well-drained RBE soils appear to be underlain by bedrock or rock lenses at fairly shallow depths (two to three meters) and have high erosion characteristics. Without adequate drainage, the soils are expected to be waterlogged quickly with irrigation and hence the area would be better suited for rice production than other crops. The LHG soils are also well suited for rice. The deeper RBE soils (over 3 or 4 m), which are found to be of only a small extent, would be suitable for growing diversified crops if drainage is provided.

3.27 Irrigation water for System C will be diverted from the Mahaweli Ganga at the Minipe Anicut and conveyed through the Minipe Right Bank Canal to the Ulhitiya and Ratkinda Reservoirs. Storage regulation will be provided by Kotmale and Victoria Reservoirs to meet the diversion demands at Minipe. In addition to the Mahaweli flows, several small tributaries along the route of the canal will provide a small contribution to the seasonal water requirements of the area. The feasibility studies conducted for the Victoria Dam Project have established that the regulation available at Victoria can meet the water requirements in both System C and System B.

3.28 The development area is divided into six zones on topographical and catchment characteristics. In Zone 1, practically all the irrigable land has already been developed and settled. Zone 2 will be irrigated from the main canal to be constructed on the Left Bank of the Ulhitiya Oya Reservoir while Zones 3 to 6 will be commanded by a main canal taking off from the Ratkinda Oya Reservoir. Distributaries and field channels will be constructed to deliver water to each individual farm. Drainage canals will also be provided as required.

3.29 The tabulation of the irrigable lands has not yet been completed, but it is expected that a total of about 21,000 ha (net) of irrigable lands can be developed for irrigation in Zones 2 to 6. Development of Zone 2 (containing about 5,200 ha) is planned to commence in mid-1980 and external financing for this development is being sought by Government. IDA has appraised the System C project and is expected to finance development in the remaining Zones 3 to 6. Zone 1 is nearly completely developed.

3.30 In addition to irrigation and drainage infrastructure, the project will provide for the development of townships and village centers, housing for the operation, management and extension staff, roads, electricity, water supplies, and other facilities connected with development activites. The total cost of the project is expected to be on the order of Rs 2,200 M excluding the cost of the Minipe Anicut, Right Bank Canal, and the Ulhitiya and Ratkinda Reservoirs.

System B

3.31 System B occupies the Maduru Oya Basin which is east of the Mahaweli Ganga Basin and separated from it by a north-south line of low hills. The irrigation area lies along either side of the Maduru Oya downstream from the Maduru Oya Dam site. The basin lies in the Dry Zone of Sri Lanka with rainfall varying from 2,946 mm to a minimum of 871 mm and an average of 1,075 mm. Seventy-five percent of the rainfall is during the north-east monsoon from October to January. The average annual volume of run-off of the Maduru Oya at the dam site is 381 M cu m and fluctuates from a maximum of 897 M cu m to a minimum of 154 M cu m. The area is comparatively undeveloped except for 4,900 ha of paddy under two major irrigation schemes, Pimburettewa and Vakaneri, and 4,500 ha under rainfed. The rest of the area is covered mainly with forests. The population of the area at present is approximately 25,000. System B lies within the administrative districts of Polonnaruwa and Batticaloa and a small part of the area near the dam site falls within the Amparai District. About 67% of the area was covered by medium-intensity soils mapping and with togographic mapping at scales of 1:5,000. Mapping of the balance area will be completed about mid-1980.

3.32 The water requirements of the Maduru Oya Basin will be supplied partly by the catchment of the Maduru Oya Basin itself and partly by the Mahaweli Ganga diverted flows. Water from the Maduru Oya Reservoir will irrigate the downstream areas by a system of main and branch canals. The left bank canal has a capacity of 48 cu m/sec and the right bank 35 cu m/sec and are respectively 55 km and 52 km long. The left bank branch canal system has a total length of 91 km and the right bank branch canal system 34 km. The design provides for a system of distributary, sub-distributary, and field channel systems, as well as main and secondary drains. It is expected to settle 31,900 farmers on an extent of 31,900 ha net irrigable paddy land. About 2,700 farmers will be settled on 5,500 ha of uplands. The total number of settlers will be 34,600. The full range of infrastructure facilities will be provided with townships, villages, and hamlet centers with different levels of facilities. A network of roads at different levels will also be provided.

3.33 The estimated project costs at mid-1979 prices are as follows:

51

	Local	Foreign (Rs M)	Total
Main and Branch Canals	460	870	1,330
Tertiary System, etc.	630	70	700
Sub-total, Irrigation Works	1,090	940	2,030
Non-irrigation infrastructure	530	50	580
Total	1,620	990	2,610

The internal rate of return of the project is estimated at 12%. The indirect and social benefits have not been taken into consideration.

3.34 The Feasibility Report for System B was prepared by the consultants ACRES International Limited of Canada engaged by the Government of Sri Lanka. USAID has indicated interest in financing the irrigation development for System B. As a first stage, USAID has agreed to finance (in a sum of US$10 million) the engagement of consultants for the preparation of final plans, designs, and estimates for main and branch canals, major structures, a pilot area of about 4,000 ha, the main drainage system, as well as for supervision of the construction of these works. Tenders for the consulting proposals closed on March 31, 1980.

System D

3.35 The area proposed for development consists of Systems D1, D2, G, and A/D (as designated in UNDP/FAO Master Plan), lying mainly in the Polonnaruwa and Trincomalee Districts. The source of irrigation water for this area is the natural run-off of the Amban Ganga watershed augmented by supplemental supplies diverted from the Mahaweli Ganga through the Polgolla Tunnel. Five large existing tanks (Kaudulla, Minneriya, Kantalai, Giritale and Parakrama Samudra) serve the presently irrigated area. The new areas proposed for development would make use of these existing tanks. Improvements would be made to about 50 km of existing canals to increase flow capacities and about 145 km of new canals would be constructed. The existing areas and proposed new areas to be developed under each system are as follows:

System	Project Area Existing	New (ha)	Total
System D1			
New sugar	-	3,800	3,800
Other Crops	12,400	9,100	21,500
System D2	10,100	2,200	12,300
System G	17,500	4,500	22,000
System A/D	-	2,600	2,600
Total	40,000	22,200	62,200

3.36 The cost of improvements and provision of irrigation and drainage facilities, development of new lands and provision of the necessary infrastructure has been estimated at Rs 900 million and the annual project benefits at full development at Rs 180 million with an internal rate of return of about 12%. Works that have so far been undertaken in this System D area consist only of topographic mapping (scale 1:5,000 with one meter contours) and soil survey and land classifications.

System A

3.37 System A is on the lowest reach of the Mahaweli Ganga extending from the Kandakadu Anicut to the river mouth of the Mahaweli over some 70 km away. The total area is about 90,000 ha within the System boundary of which about 36,200 ha can be developed under irrigation.

3.38 The consultants for the Randenigala Project were required to review the data available for System A with a view to carrying out a feasibility study combined with the Randenigala Project. However, in view of the NEDECO recommendation that the water of the Randenigala Reservoir will be surplus to the requirements of the Mahaweli and Maduru Oya Basins, System A will not require the Randenigala Reservoir for its irrigation. In view of the priority given to the feasibility studies for Systems C and B, the topographic maps, soil surveys, land classification, socio-economic data and other investigations and surveys necessary for the preparation of the feasibility study for System A had to be given low priority and is being taken up only in 1980. The consultants for Randenigala have been asked to prepare the Feasibility Report for System A and it is expected that the draft feasibility report will be available before the end of 1980.

3.39 System A will be irrigated by a diversion weir across the Mahaweli Ganga at Kandakadu or other suitable site. Alternate sites are being investigated by the consultants before they arrive at a final recommendation. The consultants have identified the areas for possible development as follows:

(a) Existing areas under the Allai Scheme (6,000 ha) and existing areas under main irrigation schemes (6,000 ha) in proximity to Allai. The consultants expect that with assured irrigation water and improved agricultural management, cropping intensities can be increased to 180% and yields by 50%.

(b) Lower Flood Plain — about 9,000 ha of alluvial soil which, though subject to flooding, can be drained as the soils are light and free-draining.

(c) Upper Flood Plain — consisting of alluvial soil area of 3,500 ha suitable for cultivation of rice in Maha and upland crops in Yala.

(d) A further extent of 15,500 ha to the southeast of the Upper Flood Plain suitable for rice, upland crops, and pasture.

III. ENVIRONMENTAL ASSESSMENT

4.01 A study of the environmental impact of the Accelerated Mahawell Program is being carried out by a firm of consultants (TAMS of USA) engaged under technical assistance from USAID. The consultants issued an Interim Report in February 1980. The following is a summary of their recommendations:

(a) Social impact of settlement in new areas: measures should be taken to monitor failure rates and causes to enable corrective planning measures to be instituted. Policies are needed to increase employment opportunities for all family members and for transfer of failed settlers to other occupations.

(b) Health: health care and sanitation facilities and potable water supply through the project area should be provided. Malaria control programs and regulation of water flows to limit breeding habitats of mosquitoes. Monitoring of health status of population especially in regard to insect vector and water-borne diseases.

(c) A comprehensive soil and watershed management program especially in the upper catchment.

(d) Firewood plantations near planned settlements, and windbreaks for certain areas. Riverine forests should be preserved to ensure that certain tree species are maintained and managed for sustained yield harvests.

(e) A monitoring program to identify problem sites as a result of irrigation especially by return flows and the effect on quality and salinity of water.

(f) Measures to increase potential of fish production: corrective measures to maintain swamps (villus) as wildlife habitats, grazing areas and for fisheries.

(g) New National Parks and migration corridors and habitat improvement in selected areas to stabilize food supplies for animals.

IV. ORGANIZATIONAL ASPECTS

5.01 The Mahaweli Authority of Sri Lanka has been set up under Act 23 of 1979 for the overseeing and control of the implementation of the Mahawell Program. The Board of Directors consists of five persons, three of whom are nominated by the Minister and two ex-officio directors, viz., the Secretary to the Ministry of Finance and Planning and the Secretary to the Ministry of Mahaweli Development. The Authority has been vested with wide powers regarding policy formulation, financial control and control of the various implementation agencies involved in the Mahaweli Program. Enabling power has also been vested in the Authority for the creation of new agencies to deal with any Special Areas or functions of the Authority. The Central Engineering Consultancy Bureau provides engineering services to the Mahaweli Authority and the Mahaweli Development Board has been vested with the functions of irrigation, land, and infrastructure development. The Authority proposes, with the approval of the Government, to create a Mahaweli Economic Agency to be in charge of settlement and post-settlement aspects of development including production, credit and marketing, promotion of agro-industries with participation of the private sector where feasible and forthcoming.

5.02 A considerable amount of hydrological investigations, mapping, geo-technical and drilling investigations, surveys and testing of construction materials had to be carried out in connection with the project headworks. Most of these investigations and surveys were carried out by the respective agencies of the Government of Sri Lanka. Some expatriate input was brought in for geotechnical investigations and drilling for the Victoria Project and for the Maduru Oya and Kotmale Projects. Detailed plans, designs, and estimates have been finalized for three of the project headworks, Kotmale, Victoria, and Maduru Oya, and tenders called for and contracts awarded. In the preparation of plans, designs and estimates, and tender documents, a considerable amount of expatriate expertise was utilized through bilateral and multilateral technical assistance, and these were completed according to the implementation program. In the construction contracts entered into with expatriate contractors, provision has been made for them to bring instructors to train skilled personnel required. Expatriate engineers from India and Burma are being recruited to meet in part the shortage of engineers for construction supervision. Additional training facilities for middle-grade technical personnel are being provided by expansion of the capacities of existing institutions and the setting up of a new training institution. Training facilities are also being expanded for skilled and semi-skilled personnel required for the implementation of the headworks, as well as for downstream development.

SUMMARY OF PROJECTS SELECTED FOR IMPLEMENTATION AND THEIR CURRENT STATUS 1/

[illegible]	Data	Estimated Hydropower Installed Capacity	Estimated Area To Be Irrigated	Estimated Cost 2/	Current Status
Kotmale	Rockfill dam, 115 m high, 600 m long, but site and design currently being reviewed.	200 MW	To increase firm water supply by about 300 M cu m annually for irrigation.	Kotmale Dam and Powerhouse, US$320 M.	Two contracts negotiated with SKANSKA (Swedish contractor) for (i) site preparation and preliminary works, US$42 M, and (ii) construction of underground works (including tunnel, power plant, and related work), US$77 M. Designs and costs estimates for dam are being finalized.
Victoria	Double curvature arch dam, 118 m high, 507 m long.	210 MW, with provision for additional 210 MW at a later stage.	53,000 ha in Mahaweli and Maduru Oya Basins (Systems C and B).	Victoria Dam, tunnel power plants, electro/mechanical equipment, and related works, US$288 M.	Construction contract awarded to joint venture of UK firms (Balfour Beatty and Co., and Edmund Nuttall and Co.). Mobilization of contractor scheduled for Summer 1980.
Randenigala and Rantembe	Randenigala; rockfill dam, 90 m high, 500 m long.	Randenigala, 126 MW.	Randenigala and Rantembe Projects will provide water to irrigate 36,000 ha in the North Central River Basins area or elsewhere in the Dry Zone.	Randenigala Dam, power plants and electro/mechanical equipment, US$154 M.	Feasibility studies completed in June 1979 by a joint venture of German-Swiss firms (Salzgitter Consult, Agar-Und Hydrotechnik, and Electro-Watt Engineering Services). Joint venture is currently preparing detailed plans, designs and estimates, and tender documents.
	Rantembe; concrete gravity, 44 m high, 415 m long.	Rantembe, 49 MW.		Rantembe Dam, power plant and electro/mechanical equipment, US$86 M.	
Maduru Oya	Rockfill dam, 40 m high, 1,008 m long.	7.2 MW	3,750 ha of existing area and 37,400 ha (net) of new land in System B (with Victoria Reservoir).	Maduru Oya Dam, outlet works, generating facilities and link tunnel, US$86 M. Engineering services and construction supervision, site preparation works, and the electro-mechanical equipment, the total project cost is estimated at US$110 M.	Construction contract awarded to joint venture of Canadian firms (Foundation Co. of Canada, All-s-Gest International, Fitz Patrick Construction and Vanin Construction). Site preparation is nearly complete and mobilization of contractor is scheduled for July 1980. A second contract awarded to a Canadian consulting firm (Crippen International) for engineering services and construction supervision. Consultant mobilized in March 1980.

[illegible]	Data	Estimated Hydropower Installed Capacity	Estimated Area To Be Irrigated	Estimated Cost 2/	Current Status
Moragahakanda	Rockfill main dam, 72 m high, 490 m long. First saddle dam; concrete gravity, 62 m high, 396 m long. Second saddle dam; rockfill, 42 m high, 490 m long.	26 MW, with provision for additional 26 MW at a later stage.	20,000 ha in North Central River Basins area or elsewhere in Dry Zone.	Moragahakanda main and two saddle dams, power plant, electro/mechanical equipment and related works, US$110 M.	Feasibility studies completed in October 1979 by a consortium of Japanese consultants (Japan Engineering Consultants and Nippon Koei Co.). Further feasibility studies, designs and tender documents delayed until transbasin diversion study is carried out under IDA-financed technical assistance project. Financing for construction not planned until after 1984 in light of Government's decision to limit investments in Mahaweli Program to Rs 18.2 B.
Right Bank Canal Complex	Minipe Anicut (210 m long), Right Bank Canal (22.4 m long), Ulhitiya and Ratkinda Dams, link canal (1 km long), and associated works.			Minipe Anicut, Right Bank Canal, Ulhitiya and Ratkinda Reservoirs, link canal, and associated works, US$92 M. 3/	Construction of Minipe Anicut and first 4.7 km of Right Bank Canal awarded to State Development and Construction Corporation. Construction of Ulhitiya Dam awarded to River Valleys Development Board. Construction of link tunnel and Ratkinda Dam awarded to Ceylon Development Engineers, Ltd. International tenders for the balance of the Right Bank Canal Complex, to be financed in part by the Bank Group, are currently being reviewed.
[illegible]	—	—	Although tabulation of irrigable lands is not yet complete, it is expected that 21,000 ha (net) of new land can be irrigated in Zones 2-6. Zone 1 is nearly completely developed.	US$140 M 3/	The Bank Group appraised the proposed project in March 1980, and is expected to provide financing for the development of Zones 3-6 of the System. Zone 2 will be developed by the Government with its own resources, with possible assistance by the UK and EEC.

ject	Date	Estimated Hydropower Installed Capacity	Estimated Area To Be Irrigated	Estimated Cost 2/	Current Status
stem B	–	–	37,400 ha (net) of new land	US$220 M	Consultants selected for preparation of detailed plans, designs, estimates, and tender documents for the main and branch canals, major structures, a pilot area of about 4,000 ha, main drainage system, and construction supervision of these works.
stem D	–	–	About 22,000 ha (gross) of new land in systems D1, D2, G, and A/D.	NA	Aerial photography, topographical mapping, and soil surveys are underway.
stem A	–	–	36,200 ha (gross) land.	NA	Aerial photography, topographical mapping, and soil surveys are underway.

All figures mentioned hereunder are rough estimates.
Costs are estimated at 1979 prices, except where noted. Cost of systems includes irrigation, land development, and infrastructure.
Mid-1980 price level.

Attachment 2
Page 1

Countries and Organizations Interested in Assisting Sri Lanka in the Mahaweli Ganga Development Program

Country	Assistance
Canada	Canada has committed Cdn $76 M (US$65 M equivalent) in the form of a concessionary loan for the construction of Maduru Oya headworks and Cdn $7 M (US$6 M equivalent) as a grant to cover engineering services and construction supervision.
Federal Republic of Germany	Grant funds for consultants' services to carry out the feasibility study, detailed design and engineering for the Randenigala/Rantembe Complex and for the feasibility study of System A. In addition, DM 400 million has been earmarked as a possible concessionary loan to help finance the construction of the Randenigala/Rantembe Complex, pending the outcome of the ongoing project appraisal.
Japan	Consultants' services, financed with grant funds, to carry out the feasibility study of the Moragahakanda Project. The report was submitted to the Government of Sri Lanka in October, 1979.
Netherlands	Grant funds for the Implementation Strategy Study carried out by Netherlands-financed consultants (NEDECO). Report submitted to Government of Sri Lanka in August, 1979. Grant funds also to help finance a Hydrological Crash Program.
Sweden	Implementation of Kotmale Project (dam and power plant) through Swedish Import Support -- about SKr 630 M (US$170 M equivalent) over the next five years.
United Kingdom	Updating the feasibility study and preparation of designs and tender documents for Victoria Dam and power plant, and preparation of the feasibility study for System C. UK has committed L 100 M (US$220 M equivalent) as a grant to help finance the construction of Victoria headworks.
United States	Study of the impact of the Mahaweli Ganga Development Program on the environment. An initial concessionary loan in the amount of US$10 M to finance the designs, tender documents and construction of the downstream irrigation works for System B, with an additional concessionary loan in the amount of US$85 M earmarked to help finance the construction of these works.

51

Attachment 2
Page 2

Organizations	
Asian Development Bank	Technical assistance grant in the amount of US$98,000 to assist in the planning of roads in the Mahaweli and Maduru Oya Basins, with possible future financing for road construction and other works in the Mahaweli Program.
European Economic Commission	EEC Special Action Credit funds in the amount of US$2 M equivalent to finance the review of designs and tender documents for the Right Bank Canal Complex and the preparation of final designs and tender documents for construction of civil works and social infrastructure for part of System C, executed with the World Bank under the Mahaweli Ganga Technical Assistance Project. Possible additional EEC financing for the construction of downstream works in part of System C.
Kuwait Fund	Expression of interest in providing financial assistance for the implementation of the Mahaweli Program.
Saudi Fund	Expression of interest in providing financial assistance for the implementation of the Mahaweli Program.
United Nations Development Program	Technical assistance grant, provided under the UNDP-financed Multi-Sector Program of Project Preparation, for financing consultants to work with Government officials in carrying out services related to the planning and preparation of final designs, specifications and tender documents for projects included in the Mahaweli Program. Additional grant funds provided for financing advisors to the Mahaweli Authority.
World Bank	Executing agency for the consultant's contract under the above UNDP-financed Multi-Sector Program of Project Preparation. IDA Credit in the amount of US$3.0 M to finance the preparation of a study of plans for conveying and utilizing surplus Mahaweli Ganga water to develop land in three alternative areas in order to select the best plan for a transbasin diversion project, as well as support for other studies and designs in the Mahaweli Program, executed under the Mahaweli Ganga Technical Assistance Project. Possible additional IDA financing for the construction of downstream works in the major part of System C.

60

FINANCING REQUIREMENTS, 1981-85

The attached table shows the estimated 1981-85 cost of carrying out the current physical plans for the major components of the Mahaweli Development Program. The current physical plans take into account modifications agreed to in 1980 to defer major work on the Randenigala Dam, to lower the height of the Kotmale Dam, and limit initial development of System B to the left bank. The $1.6 Billion total represents the best estimate that can be made at present, using a series of different sources, of the amount of funds that need to be could be expended if there were no financing constraints, i.e. the execution of work pursuant to covenants with the various donors and within the capability of the program. However, the GSL's present fiscal policies and preliminary strategy for the 1981-85 investment plan call for sharp annual reductions in the rate of real investment. If the general strategy of keeping 1982, 83 and 84 levels at those which were shown in the 1980-84 levels at those which were shown in the 1980-84 investment plan and not making any significant upward adjustments for price increases and inflation were applied to the Mahaweli capital budget, it would result in an overall investment during 1981-85 of around $1.0 billion, rather than the $1.6 billion requirements figure, an underfinancing of 38%

There will obviously have to be some degree of "give" in the rigid financial constraints imposed by a $1 billion overall ceiling on expenditure. However, even allowing for some upward adjustment, the developmentally, politically, and fiscally difficult options facing the GSL are to:

1. Substantially increase the financial ceiling for the program, either by reducing amounts available for other public investment needs or by increasing the deficit financing burden on the economy.

2. Obtain substantial increases in donor assistance which could be directed especially towards local cost of the program.

3. Redesign the structure and timetable for program implementation to stretch out and/or reduce the program even further than has already been contemplated.

4. Implement a combination of the above.

The effect of any sizeable decrease in the overall annual investment levels for the program, although it would reduce GSL deficit financing of local costs, would also result in a decrease in the amount of donor disbursements, since the latter expenditures are, in most instances, linked to the GSL undertaking related local cost activities.

The total call on GSL financing over the 1981-85 period comes to $767 million, of which $200 million relates to foreign exchange costs and $567 million to local costs, thus the emphasis on the local costs component financing of additional donor assistance in the second of the above options.

For the 1981-85 period, it is only possible to discuss the situation in very general terms. However, for 1981 it is possible to be somewhat more specific as to the relationship between meeting program requirements and budgetary ceilings imposed in pursuit of fiscal stability.

In the fall of 1980, the government formally sent the Parliament its 1981 budget proposals, which included Rs.4 billion for the Mahaweli program. Those responsible for execution of the program, on revising their cost estimates, came to the conclusion that this amount would be insufficient to carry out the level of physical work planned for 1981 and proposed an increase of about 25%. Instead, in November a decision was taken on strictly fiscal grounds, without any restudy of the plan of work, to reduce the Rs.4 billion level to Rs.3 billion. It should be noted that even with this reduction, the Mahaweli program remains the GSL's top priority, representing 24% of the total public investment budget for 1981.

The responsible officials are now trying to keep expenditures within the Rs.3 billion budget ceiling without seriously compromising the overall plan and timetable for program, by a combination of putting off certain payments until 1982, postponing execution of some activities to 1982 and future years, and trimming expenditures wherever possible. Their uncompleted calculations indicate that the entire Rs.3 billion will be needed to meet current contract and related costs, even after the above mentioned payment postponements, etc. are taken into account. At the Rs.3 billion level, they will not be able to initiate planned downstream and settlement work in Zones 3 and 4 of System C and Zones 1,2,3 and 5 of System B. Unless an additional amount can be authorized, the timetable for exploitation of these areas will be set back by one year. Even with the above steps (postponing payments, etc. and stretching out implementation), financing problems will only be postponed to 1982 and beyond.

MAHAWELI DEVELOPMENT PROGRAM
Type and Amount of Requirements and Source of Financing
1981 - 1985

	Total ($ Million)	FX Cost ($ Million)	Local Cost ($ Million)	Estimated Ext. Financing Arranged ($ Million)	GSL Requirements (In $ Million)	GSL Requirements (In Rs.2/ Million)
1. Headworks						
Kotmale 3/	452.1	339.0	113.1	118.0 (Sweden)	334.1	7,016.1
Victoria 4/	261.7	218.0	43.7	217.5 (United Kingdom)	44.2	928.2
Randenigala/Rantembe 5/	290.6	218.1	72.5	218.1 (Germany)	72.5	1,522.5
Maduru Oya 6/	100.2	80.9	19.3	66.0 (Canada)	34.2	718.2
Sub-Totals	1,104.6	856.0	248.6	619.4	485.0	10,165.0
2. Main and Branch Canals						
System B 7/	56.8	36.9	19.9	56.8 (USAID)	--	--
System C 8/ 9/	10.4	5.9	4.5	6.1 (IDA)	4.3	90.3
Right Bank Canal and Associated Works 9/	34.0	20.4	13.6	20.9 (IDA)	13.1	275.1
Minipe Anicut, Ulhitiya-Ratkinda Reservoirs and Associated Works 10/	5.5	--	5.5	--	5.5	100.0
Sub-Totals	106.7	63.2	43.5	83.8	22.9	465.4
3. Other Downstream Activities						
System B 7/	92.2	34.0	58.2	37.9 (USAID)	54.3	1,140.3
System C 8/	132.4	57.5	74.9	61.7 (IDA)	70.7	1,484.7
System H 11/	18.1	5.8	12.3	5.7 (*)	12.4	226.9
System C-Zone 2 12/	25.2	16.5	8.7	21.0 (EEC)	4.2	88.2
Sub-Totals	267.9	113.8	154.1	126.3	141.6	2,940.1
4. Main Roads 13/	14.9	7.0	7.9	10.0 (ADB)	4.9	89.7
5. Staff and Administrative Support 14/	112.6	--	112.6	--	112.6	2,364.6
Totals	1,606.7	1,040.0	566.7	839.7	767.0	16,044.8

See notes following page.

63

NOTES:

1/ Includes inflation adjustment of 10% per annum on FX costs and 15% per annum on local costs, except where noted.

2/ Local costs converted at estimated 1983 exchange rate of Rs. 21/$1, except where noted.

3/ Preliminary consultant data.

4/ From consultant's financial report, August 1980.

5/ Joint venture Randenigala feasibility report, August 1980.

6/ From consultant based on contract costs and latest scope of work.

7/ From Acres, Annex L, Table 6.1, FX component estimated to be 65% of total cost. These cost estimates are currently under review.

8/ Draft IBRD Staff Appraisal Report, October 1980.

9/ Also includes canal lining and primary and secondary drains.

10/ MDB estimate of $5.46 million rounded to $5.5 million.

11/ MDB estimate. Converted to dollars at estimated 1981 exchange rate of Rs. 18.3/$1. Includes Stage I for 1981.

12/ From consultant's feasibility study. Represents total cost, including main and branch canals.

13/ Draft Loan Agreement between GSL/ADB, Mahaweli Area Roads Development. Converted to dollars at estimated 1981 exchange rate of Rs. 18.3/$1.

14/ 10% of total cost of headworks; Minipe Anicut, Ulhitiya - Ratkinda Reservoirs and Associated Works; and System H and C - Zone 2.

* IDA, USAID, Canada, United Kingdom, Netherlands, and EEC.

PROGRAM ANNEX TO 1981
LOAN AGREEMENT
MAHAWELI SECTOR SUPPORT

Allocation of Rupees for 1981

Budget for 1981
(Rupees Millions)

Major Activity	Total	Foreign Donor	Cooperating Country	Portion of Cooperating Country Allocated to Loan
1. System H (market roads, social, irrigation, agricultural infrastructure, on-farm development, settler services portions of budget)	289	93	196	90
2. Minipe Anicut and Transbasin Canal Complex	405	130	275	200
3. Relocation of families affected by headworks				
Victoria Reservoir	25	-	25	25
Kotmale Reservoir	25	-	25	25
Total	744	223	521	340.0*

* Rupee generations in excess of this total amount may be allocated among these major activities without formal amendment of this table.

ANNEX 5

UNCLASSIFIED
Department of State

INCOMING
TELEGRAM

PAGE 01 COLOMB 06229 241111Z 1149
ACTION AID-35

65
66

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TO SECSTATE WASHDC PRIORITY 9302

ASPD

ADVANCE
ACTION COPY

UNCLAS COLOMBO 6229

AIDAC

ATTENTION: ASIA/PD

E.O. 12065: N/A
SUBJ: MAHAWELI SECTOR SUPPORT LOAN (383-0078)

1. GSL HAS FORMALLY REQUESTED LOAN FOR THIS PROJECT BY LETTER NO. CA 9/9/69D DATED DECEMBER 27, 1980 FROM RONNIE WEERAKOON, DIRECTOR OF EXTERNAL RESOURCES, MINISTRY OF FINANCE AND PLANNING. PARAGRAPH 3 OF LETTER STATES: QUOTE IN THE MEANTIME IN VIEW OF THE VERY SHORT TIME SCHEDULE AVAILABLE TO WORK TOWARDS THZ AUTHORIZATION OF THIS ASSISTANCE, I SHALL BE GRATEFUL IF YOU WOULD MAKE A FORMAL APPLICATION TO YOUR AUTHORITIES TO PROVIDE SRI LANKA WITH A PROGRAMME LOAN FOR MAHAWELI SECTOR SUPPORT IN A SUM OF US DOLLARS 100 MILLION, TO BE DISBURSED OVER THE 5 YEAR PERIOD 1981 THROUGH 1985. THE LOAN TO BE MADE AVAILABLE ON THE SAME CONCESSIONAL TERMS OF US AID ASSISTANCE, AS PROVIDED AT PRESENT UNQUOTE.

2. PLEASE ARRANGE FOR TEXT OF THIS CABLE BE INCLUDED IN PAAD HANDCARRIED TO AID/W BY JACK MILLER.
TOUSSAINT

UNCLASSIFIED

3A(1) - COUNTRY CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding source. In Part B a distinction is made between the criteria applicable to Security Supporting Assistance and the criteria applicable to Development Assistance. Selection of the appropriate criteria will depend on the funding source for the program.

A. GENERAL CRITERIA FOR COUNTRY

1. FAA Sec. 481. Has it been determined that the government of recipient country has failed to take adequate steps to prevent narcotics drugs and other controlled substances (as defined by the Comprehensive Drug Abuse Prevention and Control Act of 1970) produced or processed, in whole or in part, in such country, or transported through such country, from being sold illegally within the jurisdiction of such country to U.S. Government personnel or their dependents, or from entering the U.S. unlawfully?

   No

2. FAA Sec. 620(b). If assistance is to a government, has the Secretary of State determined that it is not controlled by the international Communist movement?

   Yes

3. FAA Sec. 620(c). If assistance is to a government, is the government liable as debtor or unconditional guarantor on any debt to a U.S. citizen for goods or services furnished or ordered where (a) such citizen has exhausted available legal remedies and (b) debt is not denied or contested by such government?

   Not to the best of Mission knowledge

4. FAA Sec. 620(e)(1). If assistance is to a government, has it (including government agencies or subdivisions) taken any action which has the effect of nationalizing, expropriating, or otherwise seizing ownership or control of property of U.S. citizens or entities beneficially owned by them without taking steps to discharge its obligations toward such citizens or entities?

   No

5. FAA Sec. 620(f); App. Sec. 10[illegible]. Is recipient country a Communist country? Will assistance be provided to the Democratic Republic of Vietnam (North Vietnam), South Vietnam, Cambodia, or Laos?

   No

6. FAA Sec. 620(i). Is recipient country in any way involved in (a) subversion of, or military aggression against, the United States or any country receiving U.S. assistance, or (b) the planning of such subversion or aggression?

   No

7. FAA Sec. 620(j). Has the country permitted, or failed to take adequate measures to prevent, the damage or destruction, by mob action, of U.S. property?

   No

8. FAA Sec. 620(l). If the country has failed to institute the investment guaranty program for the specific risks of expropriation, inconvertibility or confiscation, has the AID Administrator within the past year considered denying assistance to such government for this reason?

   NA

9. FAA Sec. 620(o); Fishermen's Protective Act, Sec. 5. If country has seized, or imposed any penalty or sanction against, any U.S. fishing activities in international waters,

   NA

   a. has any deduction required by Fishermen's Protective Act been made?

   b. has complete denial of assistance been considered by AID Administrator?

10. FAA Sec. 620(q); App. Sec. 504. (a) Is the recipient country in default on interest or principal of any AID loan to that country? (b) Is country more than one year in default on interest or principal on U.S. loan made pursuant to program for which funds appropriated under Approp. Act, unless debt was earlier disputed, or appropriate steps taken to cure default?

    No

11. FAA Sec. 620(s). What percentage of country budget is for military expenditures? How much of foreign exchange resources spent on military equipment? How much spent for the purchase of sophisticated weapons systems? (Consideration of these points is to be coordinated with the Bureau for Program and Policy Coordination, Regional Coordinators and Military Assistance Staff (PPC/RC).)

    Taken into account by AID/W

12. FAA Sec. 620(t). Has the country severed diplomatic relations with the United States? If so, have they been resumed and have new bilateral assistance agreements been negotiated and entered into since such resumption?	No
13. FAA Sec. 620(u). What is the payment status of the country's U.N. obligations? If the country is in arrears, were such arrearages taken into account by the AID Administrator in determining the current AID Operational Year Budget?	GSL payments are current
14. FAA Sec. 620A. Has the country granted sanctuary from prosecution to any individual or group which has committed an act of international terrorism?	No
15. FAA Sec. 659. If (a) military base is located in recipient country, and was constructed or is being maintained or operated with funds furnished by the United States, and (b) U.S. personnel carry out military operations from such base, has the President determined that the government of recipient country has authorized regular access to U.S. correspondents to such base?	NA
16. FAA Sec. 669. Has the country delivered or received nuclear reprocessing or enrichment equipment, materials or technology, without specified arrangements on safeguards, etc.?	No
17. FAA Sec. 670. Has the country delivered or received nuclear reprocessing, equipment, material or technology? Is the country not a "nuclear-weapon state" as defined in Article IX(3) of the Nuclear Non-Proliferation Treaty and on which detonates a nuclear explosive device?	No
18. FAA Sec. 901. Has the country denied its citizens the right or opportunity to emigrate?	No
B. FUNDING CRITERIA FOR COUNTRY	
1. Security Supporting Assistance Country Criteria	NA
a. FAA Sec. 502B. Has the Department of State made findings which indicate that the country has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, is program in accordance with policy of this Section?	

B1

b. FAA Sec. 531. Is the Assistance to be furnished to a friendly country, organization, or body eligible to receive assistance? — NA

c. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made? — NA

2. Development Assistance Country Criteria

a. FAA Sec. 102(c), (d). Have criteria been established, and taken into account, to assess commitment and progress of country in effectively involving the poor in development, on such indexes as: (1) small-farm labor intensive agriculture, (2)reduced infant mortality, (3) population growth, (4) equality of income distribution, and (5) unemployment. — Yes in CDSS

b. FAA Sec. 115. Will country be furnished, in same fiscal year, either security supporting assistance, or Middle East peace funds? If so, has the Congress specifically authorized such funds, or is assistance for population programs, humanitarian aid through international organizations, or regional programs? — No

c. FAA Sec. 116. Can it be demonstrated that contemplated assistance will directly benefit the needy? If not, has the Department of State made findings which indicate that this government has engaged in a consistent pattern of gross violations of internationally recognized human rights? — Yes, the assistance will benefit the needy directly

d. FAA Sec. 201(b)(5), (7) & (8); Sec 203; 211(a)(4), (7). Describe extent to which country is:

(1) Making appropriate efforts to increase food production and improve means for food storage and distribution. — See PAAD

(2) Creating a favorable climate for foreign and domestic private enterprise and investment. — " "

(3) Increasing the public's role in the developmental process. — " "

2d

(4) (a) Allocating available budgetary resources to development.	See PAAD
(b) Diverting such resources for unnecessary military expenditure and intervention in affairs of other free and independent nations.	It is not doing so
(5) Making economic, social, and political reforms such as tax collection improvements and changes in land tenure arrangements, and making progress toward respect for the rule of law, freedom of expression and of the press, and recognizing the importance of individual freedom, initiative, and private enterprise.	See PAAD and CDSS
(6) Otherwise responding to the vital economic, political, and social concerns of its people, and demonstrating a clear determination to take effective self-help measures.	See PAAD and CDSS
e. FAA Sec. 201(b), 211(a). Is the country among the 20 countries in which development assistance loans may be made in this fiscal year, or among the 40 in which development assistance grants (other than for self-help projects) may be made?	Yes

3A(2) - NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding source. In Part B a distinction is made between the criteria applicable to Security Supporting Assistance and the criteria applicable to [illegible] Assistance. Selection of the appropriate criteria will depend on the funding source [illegible].

CROSS-REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? IDENTIFY. HAS STANDARD ITEM CHECKLIST BEEN REVIEWED?

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. App. Unnumbered; FAA Sec 653(b)

   (a) Describe how Committees on Appropriations of Senate and House have been or will be notified concerning the nonproject assistance;

   (a) **Congressional Notification**

   (b) Is assistance within (Operational Year Budget) country or international organization allocation reported to the Congress (or not more than $1 million over that figure plus 10%)?

   (b) **Yes**

2. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

   Not required

3. FAA Sec. 209, 619. Is assistance more efficiently and effectively given through regional or multilateral organizations? If so why is assistance not so given? Information and conclusion whether assistance will encourage regional development programs. If assistance is for newly independent country, is it furnished through multilateral organizations or in accordance with multilateral plans to the maximum extent appropriate?

   No

4. FAA Sec. 601(a); (and Sec. 201(f) for development loans). Information and conclusions whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.

   (a) **No**
   (b) **Yes**
   (c) **Yes**
   (d) **No**
   (e) **Yes**
   (f) **No**

5. FAA Sec. 601(b). Information and conclusion on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise). — **See PAAD**

6. FAA Sec. 612(b); Sec 636(h). Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the United States are utilized to meet the cost of contractual and other services. — **See PAAD**

7. FAA Sec. 612(d). Does the United States own excess foreign currency and, if so, what arrangements have been made for its release? — **No**

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Security Supporting Assistance

a. FAA Sec. 531. How will this assistance support promote economic or political stability? Is the country among the 12 countries in which Supporting Assistance may be provided in this fiscal year? — **NA**

2. Nonproject Criteria for Development Assistance

a. FAA Sec. 102(c); Sec. 111; Sec. 281a. Extent to which activity will (1) effectively involve the poor in development, by extending access to economy at local level, increasing labor-intensive production, spreading investment out from cities to small towns and rural areas; and (2) help develop cooperatives, assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local government institutions? — **See PAAD**

b. FAA Sec. 103, 103A, 104, 105, 106, 107. Is assistance being made available: [include only applicable paragraph -- e.g., a, b, etc. -- which corresponds to sources of funds used. If more than one fund source is used for assistance, include relevant paragraph for each fund source.]

32b

(1) [103] for agriculture, rural development or nutrition; if so, extent to which activity is specifically designed to increase productivity and income of rural poor; [103A] if for agricultural research, is full account taken of needs of small farmers;

Yes. See PAAD discussion of purpose

(2) [104] for population planning or health; if so, extent to which activity extends low-cost, integrated delivery systems to provide health and family planning services, especially to rural areas and poor; extent to which assistance gives attention to interrelationship between (A) population growth and (B) development and overall improvement in living standards in developing countries. Is activity designed to build motivation for small families in programs such as education in and out of school, maternal and child health services, agriculture production, rural development, and assistance to urban poor?

NA

(3) [105] for education, public administration, or human resources development; if so, extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, or strengthens management capability of institutions enabling the poor to participate in development;

NA

(4) [106] for technical assistance, energy, research, reconstruction, and selected development problems; if so, extent activity is:

NA

(a) to help alleviate energy problem;

(b) reconstruction after natural or manmade disaster;

(c) for special development problem, and to enable proper utilization of earlier U.S. infrastructure, etc., assistance;

(d) for programs of urban development, especially small labor-intensive enterprises, marketing systems, and financial or other institutions to help urban poor participate in economic and social development.

(5) [107] by grants for coordinated private effort to develop and disseminate intermediate technologies appropriate for developing countries.

NA

c. FAA Sec. 207; Sec. 113. Extent to which assistance reflects appropriate emphasis on: (1) encouraging development of democratic, economic, political, and social institutions; (2) self-help in meeting the country's food needs; (3) improving availability of trained worker-power in the country; (4) programs designed to meet the country's health needs; (5) other important areas of economic, political, and social development, including industry; free labor unions, cooperatives, and Voluntary Agencies; transportation and communication; planning and public administration; urban development, and modernization of existing laws; or (6) integrating women into the recipient country's national economy.

1, 3, 4, 5, 6 - N/A
2 - See PAAD

d. FAA Sec. 281(b). Describe extent to which program recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civic education and training in skills required for effective participation in governmental and political processes essential to self-government.

Non-project assistance approach is based on high assessment of Sri Lanka's capabilities.

e. FAA Sec. 201(b)(2)-(4) and -(8); Sec. 201(e); Sec. 211(a)(1)-(3) and -(8). Does the activity give reasonable promise of contributing to the development of economic resources, or to the increase of productive capacities and self-sustaining economic growth; or of educational or other institutions directed toward social progress? Is it related to and consistent with other development activities, and will it contribute to realizable long-range objectives?

Yes

f. FAA Sec. 201(b)(6); Sec. 211(a)(5), (6). Information and conclusion on possible effects of the assistance on U.S. economy, with special reference to areas of substantial labor surplus, and extent to which U.S. commodities and assistance are furnished in a manner consistent with improving or safeguarding the U.S. balance-of-payments position.

Should increase U.S. exports to Sri Lanka

3. Nonproject Criteria for Development Assistance (Loans only)

a. FAA Sec. 201(b)(1). Information and conclusion on availability of financing from other free-world sources, including private sources within the United States.

Sri Lanka already receiving substantial assistance from other donors.

63

b. FAA Sec. 201(b)(2); 201(d). Information and conclusion on (1) capacity of the country to repay the loan, including reasonableness of repayment prospects, and (2) reasonableness and legality (under laws of country and United States) of lending and relending terms of the loan.

See PAAD. No problems anticipated

c. FAA Sec. 201(e). If loan is not made pursuant to a multilateral plan, and the amount of the loan exceeds $100,000, has country submitted to AID an application for such funds together with assurances to indicate that funds will be used in an economically and technically sound manner?

Yes. See Annex 5

d. FAA Sec. 202(a). Total amount of money under loan which is going directly to private enterprise, is going to intermediate credit institutions or other borrowers for use by private enterprise, is being used to finance imports from private sources, or is otherwise being used to finance procurements from private sources?

Dollars provided should result in increased U.S. exports. Large proportion of generated rupees will be used to fund Sri Lankan private contractors.

4. Additional Criteria for Alliance for Progress

[Note: Alliance for Progress assistance should add the following two items to a nonproject checklist.]

NA

a. FAA Sec. 251(b)(1)-(8). Does assistance take into account principles of the Act of Bogota and Charter of Punta del Este; and to what extent will the activity contribute to the economic or political integration of Latin America?

b. FAA Sec. 251(b)(8); 251(h). For loans, has there been taken into account the effort made by recipient nation to repatriate capital invested in other countries by their own citizens? Is loan consistent with the findings and recommendations of the Inter-American Committee for the Alliance for Progress (now "CEPCIES," the Permanent Executive Committee of the OAS) in its annual review of national development activities?

3A(3) - STANDARD ITEM CHECKLIST

Listed below are statutory items which normally will be covered routinely in those provisions of an assistance agreement dealing with its implementation, or covered in the agreement [illegible] (as where certain users of funds are permitted, but other uses not).

These items are arranged under the general headings of (A) Procurement and (B) Other Restrictions.

A. PROCUREMENT

1. FAA Sec. 602. Are there arrangements to permit U.S. small business to participate equitably in the furnishing of goods and services financed? NA

2. FAA Sec. 604(a). Will all commodity procurement financed be from the United States except as otherwise determined by the President or under delegation from him? YES

3. FAA Sec. 604(b). Will all commodities in bulk be purchased at prices no higher than the market price prevailing in the United States at time of purchase? NA

4. FAA Sec. 604(c). Will all agricultural commodities available for disposition under the Agricultural Trade Development & Assistance Act of 1954, as amended, be procured in the United States unless they are not available in the United States in sufficient quantities to supply emergency requirements of recipients? NA

5. FAA Sec. 604(d). If the cooperating country discriminates against U.S. marine insurance companies, will agreement require that marine insurance be placed in the United States on commodities financed? NA

6. FAA Sec. 604(e). If offshore procurement of agricultural commodity or product is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity? NA

7. FAA Sec. 604(f). Are there arrangements whereby a supplier will not receive payment under the commodity import program unless he/she has certified to such information as the Agency by regulation has prescribed? Yes

A

8. FAA Sec. 608(a). Will U.S. Government excess personal property be utilized wherever practicable in lieu of the procurement of new items? **Yes**

9. MMA Sec. 901(b). (a) Compliance with requirement that at least 50 per centum of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S.-flag commercial vessels to the extent that such vessels are available at fair and reasonable rates. **Yes**

10. International Air Transport. Fair Competitive Practices Act, 1974

    If air transportation of persons or property is financed on grant basis, will provision be made that U.S.-flag carriers will be utilized to the extent such service is available? **NA**

B. OTHER RESTRICTIONS

1. FAA Sec. 620(h). Do arrangements preclude promoting or assisting the foreign aid projects or activities of Communist-Bloc countries, contrary to the best interests of the United States? **Yes**

2. FAA Sec. 636(i). Is financing prohibited from use, without waiver, for purchase, long-term lease, exchange, or guaranty of sale of motor vehicle manufactured outside the United States? **Yes**

3. Will arrangement preclude use of financing:

    a. FAA Sec. 114. to pay for performance of abortions or involuntary sterilizations or to motivate or coerce persons to practice abortions? to pay for performance of involuntary sterilizations as method of family planning or to coerce or provide any financial incentive to any person to practice sterilizations? **Yes**

    b. FAA Sec. 620(g). to compensate owners for expropriated nationalized property? **Yes**

    c. FAA Sec. 660. to finance police training or other law enforcement assistance, except for narcotics programs? **Yes**

    d. FAA Sec. 662. for CIA activities? **Yes**

83

e. App. Sec. 103. to pay pensions, etc., for military personnel? — Yes

f. App. Sec. 106. to pay U.N. assessments? — Yes

g. App. Sec. 107. to carry out provisions of FAA Sections 209(d) and 251(h)? (transfer to multilateral organization for lending). — Yes

4. FAA Sec. 201(d). If development loan, is interest rate at least 2% per annum during grace period and at least 3% per annum thereafter. Can the country borrower service the loan on harder than standard development loan terms? — NA - Repealed

81

ANNEX 7

ENVIRONMENTAL FINDING

UNITED STATES GOVERNMENT

memorandum

DATE: January 19, 1981

REPLY TO ATTN OF: GC/Asia, Stephen Tisa SRT

SUBJECT: Mahaweli Development Sector Support Loan: Applicability of Categorical Exclusion from Environmental Review Under Regulation 16

TO: Asia/TR/STEP, Ms. Jane Stanley

This memorandum records our agreement, and reasons therefor, regarding the application of A.I.D.'s environmental procedures to the Mahaweli Development Sector Support Loan.

Facts: A.I.D. will provide approximately $50 million of local currency equivalent to the Government of Sri Lanka (GSL) in support of its local currency budget for the Mahaweli Accelerated Development Program (ADP). A.I.D.'s assistance purpose is (a) to assist in a non-inflationary manner in filling a shortfall in local currency available to the GSL to finance the estimated local currency costs of approximately $1 billion for the program during the period 1981-1985 and (b) to ensure that adequate attention to downstream development is provided in the GSL budget for the ADP.

Only Mahaweli line items identified in the capital expenditure component of the GSL's annual budget will be eligible for contributions of A.I.D. generated rupees. Priority will be given to:

1. Costs that are primarily local in nature for activities for which GSL agencies have a demonstrated capacity for budgeting, accounting, design, contracting, supervisory, and audit without expatriate assistance. (Such activities would include land clearing, on-farm development, construction of social infrastructure such as schools, health centers and community centers, construction of farm to market roads and construction of worker and settler camps.)

2. Downstream activities where expatriate design and supervision assistance has been arranged under donor financing.

3. Headworks construction in the Mahaweli program for which expatriate design assistance is being provided with donor support.

JAN 21 1981

Buy U.S. Savings Bonds Regularly on the Payroll Savings Plan

OPTIONAL FORM NO. 10
(REV. 7-76)
GSA FPMR (41 CFR) 101-11.6
5010-112

The local currency costs estimated for activities in all three priority categories is approximately $446 million. The A.I.D. loan financing would amount to approximately 11 percent of maximum GSL rupee financing requirements. During annual budget reviews, A.I.D. will agree on the attribution of A.I.D. loan generated rupees to types of activities within the priority areas but not to specific activities. For example, agreement will be reached that a certain amount of A.I.D. generated rupees will finance farm to market roads, but A.I.D. will not review, approve or control what actual farm to market roads will be financed; a certain amount of rupees will be allocated to social infrastructure which could include village centers, schools, hospitals, but A.I.D. will not review, approve or control the specific schools, hospitals or centers to which A.I.D. funds will be attributed.

This is consistent with A.I.D.'s purpose in making its loan, i.e., to provide non-inflationary local currency support for the ADP budget in downstream areas. Accomplishing A.I.D.'s purpose is not dependent upon completion of particular schools, roads or irrigation systems as long as those kinds of things are completed in the program.

Applicability of Environmental Procedures: Under these circumstances, you and I have agreed that the Mahaweli Development Sector Support Loan fits in the categorical exclusion from environmental review set forth in section 216.2(c)(2)(vi) of Regulation 16: contributions to international regional or national organizations which are not for the purpose of carrying out a specifically identifiable project or projects. The meaning of the phrase "carrying out a specifically identifiable project" is explained by the criterion for establishing categorical exclusions set forth in section 216.2(c)(1)(ii) of the procedures: environmental review generally is not required when A.I.D. does not have knowledge or control over the specific activities that have an effect on the environment and the objective of A.I.D. in furnishing assistance does not require, either prior to approval of financing or prior to implementation of specific activities, knowledge of or control over the specific activities that have an effect on the environment.

A.I.D. is not required by its environmental procedures to change its type or purpose of financing activities, and there are A.I.D. actions such as sector budget support when A.I.D.'s purpose does not require knowledge or control over the specific activities to which A.I.D. funds are attributed that will effect the environment. In such cases, A.I.D. also does not review, for example, economic, technical or social analyses of the specific activities to which A.I.D. funding is attributed. In keeping with the principle that environmental concerns should be integrated in decision-making to the same extent as technical, economic and social analyses, A.I.D.'s environmental procedures do not require review of environmental analysis of these specific activities.

Of course, A.I.D. has financed an environmental assessment of the entire Mahaweli Accelerated Development Program which is available to the GSL as it plans and designs the activities within its program.

cc: Asia/PD:RAsselin