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AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

MEMORANDUM

February 26, 1988

TO: Distribution

FROM: ANE/PD, Ronald F. Venezia *R Venezia*

SUBJECT: Sri Lanka: Rehabilitation Assistance Project
(383-0107)
Asia and Near East Project Advisory Committee

The ANPAC meeting to review subject PID will be held on Tuesday, March 1 at 10:00 AM in room 4440.

Participation in accordance with ANE Bureau guidelines is invited.

Attachments: Issues Paper

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ISSUES PAPER

SRI LANKA: REHABILITATION ASSISTANCE PROJECT (383-0107)
PROJECT IDENTIFICATION DOCUMENT

LOP Funding: \$50 million, ARDN Grant (changed from ARDN/SDA split indicated on PID facesheet)

Initial FY: 1988
Final FY: 1990
PACD: 1992

A. Summary Project Description

This project will carry out the USG pledge of assistance to Sri Lanka in response to the signing of the Indo-Sri Lankan Peace Accord in July 1987, by helping to rehabilitate and reconstruct strife-torn areas of the Northern and Eastern Provinces. The project aims to promote incomes, employment and agricultural productivity in these regions by assisting in the restoration of a viable productive economy.

The project will focus on the following sectors:

1) Agricultural production: \$10 million will be provided for subsidized production loans to permit farmers to resume cultivation starting with the October 1988 planting season, to buy productive inputs and tools, and to generate sufficient incomes from the initial growing season to meet subsequent seasons' product costs and farm families' consumption needs. In-kind loans will be provided through a variety of local financial intermediaries, probably over a phase-out subsidy program covering two or three cropping seasons.

2) Irrigation: \$18 million will be used to repair damaged or deteriorated gravity irrigation and groundwater systems, repair related infrastructure and replace vehicles and equipment lost by the GSL Irrigation Department during the four years of ethnic conflict. Construction will be carried out by local firms under contract to the Irrigation Department. Some technical assistance and training will be included.

3) Private Sector: \$12 million will support grants, loans and/or guarantees to reactivate private commercial and industrial businesses that were damaged or abandoned in the conflicts, as well as to help create new enterprises in the region. An entrepreneur development component will provide TA and training through private firms or PVOs, and a business infrastructure program will rebuild such supporting facilities as banks, warehouses and market stalls.

4) Housing: \$10 million (supplemented by \$15 million HG) will provide grant/loan packages to the estimated 100,000 families whose homes have been destroyed and 85,000 damaged, with the grant/loan split and the lending terms determined on the basis of income. This component will be fully coordinated with the existing USAID HG program and the GSL's "Million Houses" program. Various financial intermediaries (notably PVOs and Thrift and Credit Cooperatives) will service the loans and will receive TA and training under the project. In addition, enterprises producing building materials will be offered grants or loans to ensure the adequacy of these materials to meet rehabilitation needs.

B. Issues Discussed in Project Committee

The Project Committee met on February 23 and identified the following issues and concerns for ANPAC consideration:

Issue 1: Dual focus on rehabilitation and regional development: The project as currently described will go beyond the immediate reconstruction needs of the target groups to a larger and longer-term focus on restoring the viability of the regional economy. This is particularly evident in the proposed support for new business enterprises. Is this dual focus appropriate? Does the dichotomy create excessive complexity and implementation problems (e.g., a need for long-term technical assistance in addition to fast-disbursing financial assistance)?

Discussion: In the PRC discussion, the Mission emphasized that the situation in the North and East differs from that faced in rehabilitation projects after earthquakes, floods, etc. in that five years of gradual economic decay, abandonment, and intermittent hostilities have fundamentally undermined the regional economy. The GSL believes that the best prospects for a lasting peace lie in the creation of economic opportunity for residents of the North and East, especially for the young unemployed who have made up the backbone of the insurgency. In addition, decision-making must be decentralized to the fullest extent possible in order to be credible to citizens of the affected areas. Rebuilding the regional economy will require both a short-term "jump start" and a long-term developmental effort. The project seeks to provide the "jump start" via subsidized agricultural inputs and irrigation repairs and building materials for homes and existing businesses. Technical assistance and institutional strengthening would be directed primarily at entities (such as local government agencies, credit societies or cooperatives) that must play an intermediary role in these short-term activities. Possible support for new businesses -- the element of the project that is least formulated at this point -- would aim at longer-term development.

Recommendation: The project should concentrate first on short-term needs, while remaining open to longer-term development opportunities. TA should focus primarily on getting the intermediary institutions to the level of functioning necessary to deliver immediate and essential services. The Mission may wish to consider deferring the private sector component to a second phase, or at least focusing it primarily on building up enterprises that supply essential commodities and services directly related to rehabilitation efforts.

Issue #2: Host Country Contribution: The USG joined other donors at the special Paris meeting on Sri Lanka in supporting the idea of full project financing of rehabilitation costs to avoid increasing Sri Lanka's external debt burden. Does the project meet the Handbook 3 test for an exception to the statutory requirement for a 25% host country contribution? Alternatively, can the contribution requirement be met through attribution of other donors' resources and other funds such as local currency generations from PL-480? Would such local currency need to be earmarked for specific rehabilitation activities to meet attribution requirements?

Discussion: The Mission Director indicated to the PRC that it is the preliminary opinion of the regional legal advisor in Colombo that the project, as an integral part of the multi-donor rehabilitation program, meets the requirement for an exception to FAA Section 110 by virtue of being an "authentically multilateral" activity. On the other hand, the PID facesheet indicates a host country contribution of \$55.9 million; its source was unclear to the project committee. It may be possible to attribute (among other resources) local currency generated by PL-480 and used by the government to provide in-kind assistance to the affected region. The committee recognized that general budget support may be as critical to the success of the peace process as specific rehabilitation financing, but suggested that at a minimum the Mission may wish to exchange side letters with the GSL indicating that local currency generated by the PL-480 component of the rehabilitation component -- which is expected to consist of \$10 million in Title I -- will be used for related purposes.

Recommendation: The Mission should satisfy itself definitively on the question of the project's eligibility for an exception to section 110. It may also wish, however, to calculate what resources the host country is, in fact, contributing, and to pursue at least an informal (if not formal) understanding with the GSL regarding use of the PL-480 local currency provided under the program.

Issue #3: Credit Modalities and Related Policy Implications:
The PID proposes a mix of grants and subsidized credits for housing, agricultural inputs and private enterprises. How does this plan relate to current AID policies regarding subsidized credit? Are there alternative mechanisms available, such as outright grants-in-kind of building materials, inputs, etc. that will efficiently provide basic resources to the most needy groups? What criteria and selection procedures will be used to assess needs, identify eligible borrowers/grantees, establish appropriate assistance packages and set the terms of repayment?

Discussion: The target group is generally poor, displaced, unemployed and uncreditworthy as a result of having lost their previous homes, livelihoods and abilities to service old loans; these conditions comprise the basic *raison d'etre* of the project and, by definition, require extraordinary approaches. The World Bank has recognized this in deciding against any policy conditionality for its assistance and in not applying normal economic criteria to its project appraisal. The Mission emphasized the need for donors to be consistent in their requirements. The project committee generally acknowledged the appropriateness of this approach, but sought to ensure that at a minimum the project would avoid reversals of recent progress in instituting market interest rates and criteria in agricultural and housing programs. Some on the committee argued for direct grants, perhaps under in-kind voucher systems, for the most needy groups rather than use of subsidized credit systems, with additional emphasis on beneficiary selection/monitoring and functioning input delivery systems. At the same time, the appropriateness of grant assistance to private-sector entrepreneurs was questioned. The Mission explained that the district-level government agents and reconstruction coordinating committees would establish standard procedures for establishing target groups, needs and assistance packages.

Recommendation: The Mission should explore alternatives wherever possible (e.g., combinations of grants and market-rate loans) before committing itself to subsidized credit under the project. Where subsidies are used, they should be transparent and well justified and should lie within parameters established in the project paper. Grants to private enterprises appear unjustified; if anything, term lending appears more appropriate. A rigorous evaluation mechanism should be built in, using the experiences in IG recent oversight of other rehabilitation projects.

Concern: Potential Disbursement Bottlenecks: Timely delivery of the necessary commodities and services will be a substantial challenge even under the assumption of a secure peace. How will the Mission avoid such potential bottlenecks as building material shortages, protracted GSL procurement procedures and limited capacity of the local construction industry?

Discussion: The Mission is fully aware of this concern, particularly with regard to the irrigation component and procurement generally, and is addressing it in the forum of the National Reconstruction Steering Committee. It may be appropriate to include a covenant requiring streamlined procurement procedures.

C. Project Committee Recommendation

The Project Committee recommends ANPAC approval of the PID and delegation of project paper approval to the Mission.

D. Project Committee Members

ANE/PD/SA, Pamela Baldwin, Chairman
ANE/PD, Bruce Odell
ANE/PD/PE, David Hagen
ANE/SA, David Garms
ANE/TR/ARD, John Anania
ANE/DP, Arthur Silver
PPC/PB, Linda LeDuc
GC/ANE, Herbert Morris

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