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Country Development Strategy Statement

FY1985

Sri Lanka

January 1983

Agency for International Development
Washington, D.C. 20523

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COUNTRY DEVELOPMENT STRATEGY STATEMENT UPDATE

FY 1984 - 88

UNITED STATES AID MISSION TO SRI LANKA

Prepared January 1983

UNCLASSIFIED

THE AMBASSADOR
OF THE
UNITED STATES OF AMERICA
Colombo, Sri Lanka

January 19, 1983

CHIEF OF MISSION COMMENTS

I am pleased to endorse the Country Development Update prepared by the USAID Mission, Colombo.

The strategy reflects a continuation of U.S. emphasis in three major areas:

(1) Mahaweli Basin development;

(2) food production and natural resource management;

(3) human productivity and well-being.

The development assistance levels proposed represent a gradual shift of resources from the Mahaweli program to other agricultural-related activities.

The strategy, in my judgment, is a sound assessment of Sri Lanka's development needs and priorities and I am pleased to support the programs as outlined.

John H. Reed

John H. Reed

EXECUTIVE SUMMARY

The CDSS period 1984-1988 coincides with the second term of the UNP government which was returned to office in the fall of 1982 for a second six-year term, beginning in 1983. We are confident, therefore, that the sound market-oriented development policies instituted by President Jayawardene in 1977 will be continued and strengthened. Consequently, in line with AID/W policy directives and assurance of continuity in GSL economic policies, the Mission has developed goals and targets, both for the Agency's priority areas and our program areas of emphasis. We believe these goals, given policy continuity and adequate resources, are all achievable by 1988, and some even earlier.

1982 has been a difficult year for Sri Lanka. A serious drought reduced agricultural production while constraints on the capital budget slowed down the pace of development. However, in spite of these problems, unemployment remained at 15% (down from a high of 24% in 1977) and GDP grew by 5%. Several of the GSL's major projects started in 1977-78 are nearing completion. During the CDSS period, the GSL plans to shift resources from capital intensive projects (principally the Mahaweli) to a greater emphasis on agricultural production, health, energy, education, and natural resource management. The USAID strategy, set forth in this CDSS and as approved in the 1981 CDSS, responds closely to GSL priorities and AID/W policy directions.

The four key areas of concentration in the development and management of our programs are those set forward by AID/W (e.g., policy dialogue, the private sector, institution building and training, and technology transfer and research) and will continue to be the basic tools of our program. A careful review of the program indicates that all have been used extensively and with good results. However, we plan to intensify our activities and have developed a series of goals which we expect to be met by the end of the CDSS period, if not before.

Some examples of these goals are listed below with a fuller discussion in the body of the CDSS.

Policy Dialogue

We will continue to impact on the on-going review of macro-economic policies through:

1) the annual Consultative Group meeting at which all donors review Sri Lanka's policies, and

2) on a regular basis in Colombo, our analysis and review with the IBRD and IMF of macro policies, particularly those which have an impact on our program.

However, we continue to believe that we can have a greater impact on sectoral policies which can have a major impact on the macro economy.

Several goals which our policy dialogue will help meet are:

- a shift in the GSL housing policy to a point where the

private sector is providing the bulk of financing for the sector and the low-cost housing programs are self-sustaining;

- the expansion of the private sector's role to a point where its contribution to total investment is well over 50%; and

- the development of national energy policies and the initial implementation of energy sector plans.

Private Sector

Some of our private sector goals to be addressed, both through our private sector project and private sector emphasis, in the overall program are:

- the private sector being the principal employer of new entrants into the labor force;

- the private sector being the principal means for processing and marketing agricultural produce; and

- a significant increase in Sri Lankan and U.S. agro-industrial investments in Sri Lanka.

Institutional Development and Training

Some of our key goals in this priority area are:

- an on-going Sri Lankan capability to generate and analyze agricultural data in a rational manner will be in place;

- GSL agencies involved in the irrigation sector will have institutionalized farmer organization, operations and maintenance systems, and cost recovery principles into their efforts; and

- linkages between water and sanitation systems, health

education, community involvement and user fees will be strengthened and included as key elements in the investment program.

Technology Transfer and Research

Some of the key goals in this priority area are:

- Sri Lanka possessing a self-sustaining rice research capability;
- the more direct linkage of AID-sponsored pilot efforts to the private sector and expansion of its technological and research capabilities;
- strengthening of Sri Lankan institutional capabilities to identify and apply appropriate technologies; and
- the carrying out of experimentation in non-traditional energy sources which can feed into the policy dialogue on energy.

The USAID program is designed overall to help Sri Lanka build the capacity needed for self-sustaining growth. While the CDSS period will see a shift in resources from Mahaweli construction to agricultural production, natural resource management, and human productivity and well-being, our objectives (food production, employment generation and human productivity and well-being) remain unchanged. Following a careful review of the project portfolio, we continue to believe that the three program emphasis of the approved strategy, as set forth below, continue to respond to AID/W policies and Sri Lankan priorities.

Our major assistance categories are:

1. Mahaweli Basin Development

The CDSS period will see the completion of major downstream irrigation works. Our program will then turn to an emphasis on the settlement and agricultural aspects of the program. During this period, we expect to see a substantial increase in private investment in agro-industry in the Mahaweli areas, an announced policy goal of the GSL. During the CDSS period, our contribution will be $95 million in development assistance to: a) complete the major irrigation works, b) intensify the settlement and agricultural support aspects, and c) to complete support for a program to ameliorate the environmental effects of the Mahaweli program.

2. Food Production and Natural Resource Management

This element covers the improvement of irrigation and water management, expansion of food production with an increased concentration on subsidiary field crops (coarse grains, oil seeds, and pulses), and provision of assistance in overall agricultural policy and planning in support of a comprehensive national agriculture, food and nutrition strategy. In addition, building on earlier efforts, a strong emphasis will be placed on retarding the rate of natural resource degradation and increasing energy sources, principally fuelwood, for the rural poor. During the CDSS period, our estimated contribution will be $218 million in development assistance and PL 480, Title I.

3. Human Productivity and Well-Being

As GSL resources devoted to capital investment taper down, plans are to strengthen and rationalize basic environmental conditions and services impacting on health. Our program will place a strong emphasis on preventive health care and environmental sanitation. We will continue to assist the GSL to improve the health of mothers and children through our PL 480, Title II programs while, at the same time, encouraging the GSL to increase indigenous resources for these programs.

We will continue to support the GSL shelter program through our Housing Guarantee program, directing our efforts toward policy change, leading towards long-run sustainability. Our private sector initiative is also included in this category with its major objective of increasing productivity and employment. During the CDSS period, our estimated contribution to this category will be about $105 million in development assistance and PL 480, Title II, in addition to $125 million of non-appropriated funds from the Housing Guarantee program.

Total U.S. assistance levels, composed of development assistance, PL 480 commodities and housing guarantees are estimated at an average annual level of about $108 million through the CDSS period.

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INTRODUCTION

In response to guidance from AID/Washington, the FY 1984-88 CDSS update for Sri Lanka will principally focus on the review of AID's current priority areas and the impact of these upon our approved strategy and goals for the CDSS period. With the recent return of the United National Party (UNP) to office, the basic economic policies supported by the Government of Sri Lanka (GSL) since 1977 are expected to be continued. Thus, much of the background information and analysis of government policies remain unchanged and will only be highlighted in this document. Consequently, this CDSS update should be read in conjunction with the approved CDSS and last year's CDSS update.

I. DEVELOPMENT AND ECONOMIC OVERVIEW

A. Background, Policy Framework, and Development Strategy

Sri Lanka's generous social welfare policies since indepnedence in 1948 have enabled the country to enjoy extremely high quality of life indicators even though economic growth and per capita income remained very low. These very costly welfare policies have been radically changed since the election of the UNP in 1977. The GSL policies have diminished government intervention in the economy and have resulted in an average GDP growth rate of about 6% and a substantial increase in employment opportunities. Heavy donor funding of development projects has assisted the GSL in achieving these results. Unfortunately, the ambitious investment

program has been accompanied by an average inflation rate of about 20%.

During the next phase of the GSL development plan, the 1982-86 period, the GSL remains committed to the objectives of accelerated economic growth and employment generation while safeguarding the living standards of the poor. With a planned investment level of $4.5 billion, the GSL will decrease expenditures on the Mahaweli Development Program and shift resources towards major rehabilitation of economic and social infrastructure, partly designed to provide the support needed for private sector development. Priority during the plan period will be given to quick yielding, production-oriented projects; increasing exports; infrastructure needs in power, transport and communications; an improvement in management; and research and extension.

B. Current Economic Situation

1. Highlights

A more complete macro-economic review is contained in Annex A. The highlights of this review follow below.

Current evidence suggests that the GDP growth rate will fall to about 5% for 1982 compared to 5.8% in 1981 largely due to the effects of drought and floods on paddy and tea production. Performance in other sectors of the economy was up from 1981, except for private sector growth which was sluggish due to the uncertainties surrounding the elections. With the presidential elections and the referendum now complete, the stage is set for continued private sector growth.

Inflation is expected to average only 10% for 1982 due to a combination of factors such as lower world food and oil prices; under-expenditure of the 1982 budget; restrictive monetary policies and an overvalued exchange rate.

The employment generating capacity of the economy slowed down in 1982 due to slower private sector growth and to the limited potential for new employment in ongoing development projects.

There is expected to be little change in the balance of payments in 1982 compared to 1981. The trade deficit will amount to about $800 million, the debt service ratio will rise to 14.5%, and gross foreign exchange reserves will cover about two and a half months imports.

It is expected that 1983 will be a difficult year economically for Sri Lanka with anticipated higher budget deficts and inflation rates.

2. Implications for Donor Financing

The principal source of external assistance to Sri Lanka has been the Sri Lanka Aid Group formed in 1965. The group is composed of thirteen countries and five international organizations which meet once yearly to coordinate and pledge assistance to the country. Between 1977 and 1981, overall levels of annual aid commitments more than tripled to $815 million and the composition of this aid shifted heavily to project assistance (84%). Support for the Mahaweli Development Program has accounted for over 40% of total project aid commitments since 1977.

The inflationary spiral of recent years, as well as

initial under-estimation of costs for the Mahaweli Program, resulted in large financing gaps. This forced the government to put the squeeze on other investments and to appeal to donors for a shift towards larger elements of non-project assistance for use as general budget and balance of payments support. The budget squeeze has become so severe that a general moratorium has been imposed on all new projects through at least 1983.

Aid commitments rose to a record of $815 million in 1981, followed by $668 million in 1982 and a World Bank projection of $455 million in 1983.

The rapid rise in aid commitments since 1977 has so far only partly been reflected in increased disbursements. The pipeline of undisbursed aid has grown rapidly, increasing by 250% between end-1977 and end-1981, due largely to the rapid acceleration in aid commitments themselves and the shift towards project aid.

A table detailing estimated disbursements of donor assistance for the first nine months of 1982 is in Annex B.

II. AID'S PRIORITY AREAS

A. Policy Dialogue

1. Use of Policy Dialogue, and Need and Potential for Policy Change

The USAID firmly believes a cooperative approach is absolutely essential to the conduct of the U.S. foreign assistance program and policy dialogue with the GSL. Further, this approach must reflect the human and financial resources available to the USAID, the focus of our strategy and program, and AID's willingness to become directly involved through the provision of technical and other assistance in the resolution of the policy issues at hand.

The situation the USAID encounters in Sri Lanka is in many ways enviable. The country is recognized to have a well-qualified civil service which prides itself on its ability to develop generally sound economic policies. To an extent, the soundness of Sri Lankan policies is the result of prior and on-going discussions we and other donors have conducted with the GSL over the past five years, during which the GSL has undertaken significant policy reforms, most of them positive in their impact. These reforms have included reducing the role of the government, a freeing up of the private sector, and the decontrol of food prices.

The USAID's approach is to emphasize support for the GSL's basically sound policies in the context of discussions on the overall U.S. assistance program and negotiations of its larger components such as the PL 480, Title I, program. In addition, the

USAID concentrates on sector and sub-sector policies and on project implementation procedures, e.g., the increased use of private sector contractors for design, supervision and construction in lieu of solely public sector involvement.

In addition, due to staff limitations and the agricultural focus of our program, the USAID avoids areas or sectors where others are actively involved. Examples would include tariff reform, balance of payments, and the tree crop sector where the IMF, World Bank, and other donors are concentrating. Concurrently, the USAID does not hesitate to lend support to IMF or World Bank-recommended macro-economic changes which our independent analyses and judgments support.

The principal focus of the AID strategy is in support of the GSL's objectives for the agricultural sector, i.e., to increase production, employment, and incomes. To this end, the USAID has encouraged the GSL to develop a national agriculture/food/nutrition strategy. This is seen as being especially important as Sri Lanka approaches rice self-sufficiency and future investments in the agricultural sector are being actively considered. Such encouragement was contained in the FY 1982 and FY 1983 Title I agreements as the principal Self-Help Measure. Subsequently, the GSL has requested and AID has agreed to assist in the development of the national strategy. The USAID believes the development of such a strategy is critical to the future of Sri Lanka's agricultural sector and AID's future support to it.

In addition, the USAID is supporting certain specific

policy changes now underway or being considered including, for example, the further privatization of seed production and input supply, reduced production subsidies, and a greater role for private firms in the conduct of socio-economic research. Through such assistance, AID will play a cooperative and constructive role in helping the GSL to improve its agriculture and related policies.

The GSL is aware of the need for major reforms in its subsidies to the capital and recurrent costs of constructing, operating and maintaining irrigation and water supply and sanitation systems. The need also exists to shift its policy direction from a public to private sector financed housing industry. Some shifts or changes in policy have already taken place.

In the irrigation sub-sector, the USAID has established dialogues with both the Ministries of Mahaweli Development and Lands and Land Development on ways to increase farmer participation in financing, designing, constructing, operating and maintaining irrigation systems. The USAID is pushing hard for the establishment and collection of water user charges adequate to operate and maintain irrigation systems, which we will encourage to be eventually raised to recover part or all of the capital investment costs of the systems. An initial effort in this area was to provide technical assistance in drafting a new Water Resources Act and an amendment to the Irrigation Act. The final drafting of these is now being done and they are expected to be submitted for Parliamentary approval in mid-1983. These new Acts will provide

for establishing water user charges, water user associations and a water courts system for the enforcement of new water charges and water control laws.

With regard to water supply and sanitation, the USAID has also established dialogues with both the Ministry of Local Government, Housing and Construction and the National Water Supply and Drainage Board on ways to increase community participation in financing, designing, constructing, operating and maintaining of water supply and sanitation systems. The USAID is encouraging the establishment and collection of water user charges adequate to operate and maintain water supply and sanitation systems, which will eventually be raised to recover some or all of the capital investment costs of the system. Our initial efforts have been through technical assistance under the Market Town Water Supply project in Jaffna to help develop water user charges and methods for collection. Discussions are now underway to make community participation and adequate financing mechanisms a requirement prior to future AID participation in the rehabilitation of existing or construction of new water supply systems.

AID's Housing Guaranty Program has focussed on both policy change and reform, as well as improved management efficiency and institution building. The underpinnings of a viable housing system must incorporate the principles of: (1) cost effectiveness; (2) cost recovery; (3) availability of long-term financing; and (4) a viable private sector housing industry system. One and a half years ago, none of these elements were highly evident in Sri

Lanka. The GSL was builder, financer, selector, collector and proprietor of the housing sector. While the GSL was filling a critical need, AID concluded that it could best help by assisting the GSL to put its program on a sounder footing.

To achieve this objective, AID is improving current housing institutions and encouraging the GSL to shift its policy direction from public sector to private sector shelter provision. Towards this end, AID is assisting the GSL in the creation of a Housing Finance Bank (HFB).

The effect of this shift will be multi-fold. Firstly, the private housing sector which has been all but non-existent will be center stage. Secondly, the government will move towards an exit in the building of houses. Thirdly, the real cost of money will be reflected in the sector. This practice will: (1) provide the environment in which private banks and developers can flourish; and (2) dictate standards and approaches which the Sri Lanka society can realistically afford. Finally and perhaps most importantly, the shift to a banking operation away from a highly subsidized operation signals to other sectors that the GSL has decided that its economic model must move more specifically towards the market.

Another area where AID has had a significant impact upon GSL policies and programs relates to the environment, especially in connection with the massive Mahaweli Ganga development program. An AID-financed comprehensive environmental assessment of the Mahaweli program area was undertaken in 1979-80, and a program to address the critical deforestation problems in and around the Mahaweli area

was mobilized with multi-donor support, including AID assistance for reforestation of about 45,000 acres. There followed the preparation of an environmental plan of action. In line with a key recommendation of the environmental assessment, AID is supporting the establishment of natural habitats for wildlife for the Mahaweli program area to conserve wildlife species and reduce the vulnerability of agriculture and human settlements to wildlife. AID's support for environmental matters has stimulated policies and activities to address other national environmental concerns, as well, such as coastal conservation, and has increased the interest of other donors. The USAID is also assisting the recently established Central Environmental Authority which is responsible for environmental policy in Sri Lanka.

In support of AID's private sector initiatives, the USAID will undertake a private sector assessment and the development of a private enterprise development program for Sri Lanka. These will impact upon future GSL policies related to the private sector. The expansion of the private sector's contribution to Sri Lanka's development over the past four years has been impressive. However, constraints exist in areas such as export promotion, credit, capital markets, production efficiencies, quality control, and market and management development which are proposed to be addressed with AID assistance.

In addition to its impact upon GSL policies through the activities noted above, the USAID has and will continue to encourage policy changes directed at:

(1) the rationalization of investments in the health sector including the improvement of primary health care services with increased emphasis on preventive health care, population planning and service delivery; and

(2) the development of policies and plans in the energy sector, which will emphasize renewable energy resources.

2. Goals

By 1988 we expect the results of our policy dialogues with the GSL will have contributed to:

(1) the implementation of the agricultural, food and nutrition strategy being well underway and the USAID taking a direct role in affecting agricultural sector policies through the strengthening of GSL policy and planning capabilities;

(2) a system of adequate water charges for both irrigation and water and sanitation systems being established and functioning throughout the country;

(3) a shift in the GSL's housing policy to a point where the private sector is providing the bulk of financing for the sector, and low cost housing programs incorporate the principle of cost recovery;

(4) the development of national environmental policies and the organizational capacity to implement sound environmental plans;

(5) the expansion of the private sector's role to a point where its contribution to total investment is well over 50%;

(6) the implementation of a cost-effective preventive health care program; and

(7) the development of a national energy policy and the initial implementation of energy sector plans.

B. The Private Sector

The USAID is planning a FY 1983 private enterprise project which will include a detailed sector assessment. This assessment will provide a thorough description of the private sector and an analysis of the policy environment and constraints to further private sector expansion. The assessment will also provide a base for AID's future private enterprise undertakings. Below is a brief summary description of the Sri Lankan private sector as we currently know it. A more detailed analysis is presented in Annex C.

1. The Role of the Private Sector in Sri Lanka

It is roughly estimated that the private sector makes up about 55% of GDP and provides about 58% of the country's employment opportunities. The private sector dominates wholesale and retail trade, rice and coconut production, and accounts for two-thirds of the rubber production. However, in tea production, the private sector controls only one-third of the total acreage.

A few large public sector corporations still dominate industrial output, but there is a strong and growing private small and medium industrial sector which accounts for about 40% of industrial GDP. The government also dominates the construction sector, but its role is expected to diminish in the future.

The banking system is still dominated by two state banks, but the system has been opened up recently with 19 foreign (of which four are U.S.) banks entering the market.

Gross domestic investment in 1981 totalled about $1.2

billion or 29% of GDP, up from $575 million in 1977. The government accounted for 60% of this investment, but by 1986 it is expected that investment levels will fall to 26% of GDP with public and private investment levels about equal.

Current government policy strongly encourages the development of the private sector and the GSL has established institutions such as the Greater Colombo Economic Commission, the Export Development Bank and the Foreign Advisory Committee to promote private investment. These policies will certainly continue during the government's next six-year term.

2. AID's Efforts to Support the Private Sector

Although the bulk of the projects in the USAID's portfolio were developed prior to AID's private sector initiative, we have supported the GSL's policy of private sector expansion.

In the agricultural sector, for example, significant increases in per acre rice yields and total acreage under cultivation greatly enhanced the role of the private sector all the way from private seed producers, growers and input outlets through buyers and processors of harvested rice. In more recently developed activities, the USAID is promoting private enterprise involvement in the following ways:

(1) work with the recently initiated integrated national agriculture, food and nutrition strategy will assist the GSL to better identify and prioritize investment opportunities in the agriculture sector for public and private investment and to develop policies and procedures which would promote such participation;

(2) the Diversified Agricultural Research, Production and Marketing project will encourage private production of certified seed, and will promote private sector participation in providing agricultural inputs and in marketing farm produce;

(3) USAID support provided to the Market Research Unit of the Agrarian Research and Training Institute will assist the GSL to develop policies promoting increased private participation related to agricultural production and marketing;

(4) USAID's irrigation assistance efforts (including the Mahaweli) finance major contracts with U.S. firms and are improving the capacity of local contractors. We have encouraged the use of private companies for carrying out feasibility studies, and design and supervision of construction. Also, the USAID is supporting the development of private marketing and credit organizations in the Mahaweli and other irrigation areas, as well as the development of private companies in the local manufacture and fabrication of components for water supply systems and small hydro-power turbines and generators.

While the U.S. and Sri Lankan private sectors have been primary beneficiaries of the USAID's development efforts as noted above, the conditions are now right for new project interventions to stimulate a more rapid growth in the private sector. To this end, the USAID has jointly evolved with representatives of the Sri Lankan public and private sectors a private sector assessment and an initial Private Enterprise Promotion project that will:

(1) contribute to the creation of the proper local

environment for rapid growth in the private sector;

(2) identify specific sub-sectors where Sri Lanka has a comparative advantage;

(3) prepare pre-feasibility studies for those industries that will yield the most return to the national economy;

(4) bring investment opportunities to the attention of local and foreign investors;

(5) assist in the support areas of market development, management training activities and entrepreneur development.

The Private Enterprise Bureau-sponsored Joint Agricultural Consultative (JAC) Corporation will likely play an important role in arranging joint ventures or technical assistance between the U.S. and Sri Lankan agro-industrialists.

These interventions have been tailored to meet Sri Lanka's needs and should leverage the results that can be achieved with relatively small amounts of AID assistance. The primary objective of these efforts is to increase significantly the amount of new investment by the private sector until it attains a level at which it will be contributing the majority of new investments to the national economy.

Future AID efforts are currently envisioned to include refining the private sector strategy and plan, expanding managerial and entrepreneurial development efforts, conducting pre-feasibility studies and assisting selected investments, technology transfer or joint ventures. Specific attention will be given to exploring and

developing mechanisms to increase private sector access to credit.

3. Goals

By 1988, we expect our efforts will have contributed to:

(1) an emphasis in our program, and those of the GSL and other donors, on the expanded use of the private setor;

(2) the private sector being the principal employer of new entrants in to the labor force;

(3) the private sector being the principal means for processing and marketing agricultural produce;

(4) a significant increase in U.S. agro-industrial investments in Sri Lanka;

(5) actions being undertaken to address the constraints to be identified in AID's private sector assessment;

(6) the greater use in the AID program of appropiate technologies produced by the Sri Lankan private sector;

(7) private sector management training and entrepreneurial development capabilities being established and functioning on a self-sustaining basis; and

(8) mechanisms being explored and in place for icreasing private sector access to bank credit.

C. Technology Transfer and Research

1. The Sri Lanka Setting

As noted in last year's CDSS, Sri Lanka's situation makes it a candidate to take advantage of developments in and the transfer of technology. The country offers a highly literate population; a large pool of educated, trained and adaptable

workers; the availability of many raw materials; access to attractive markets in the Near and Middle East and Africa; and economic policies supporting the process of technological change.

However, the indigenous scientific and technological infrastructure and capability suffer serious problems. These problems include: (1) inadequate capacity in research and development resulting in deficiencies in the transfer, adaptation and innovation of technology; (2) inadequate managerial capacity; (3) lack of easy access to scientific and technological information; (4) the heavy exodus of trained manpower (doctors, scientists, engineers, technicians and skilled workers) - the expertise available in Sri Lanka is of a very high standard, but is in short supply; and (5) the inadequacy of training facilities for increasing the numbers of skilled personnel, particularly at the technician level. The lack of effective management institutions is also a serious problem.

As the country's economy expands and diversifies, increasing demands and opportunities will exist in areas such as agro-industry, export-oriented manufacturing in higher technology products, energy and construction to apply technologies which can contribute to Sri Lanka's self-sustaining growth.

2. AID's Current and Proposed Efforts to Increase Technology Transfer and Research

Under USAID's ongoing program, efforts have been directed to increasing technology transfer and research. In the agricultural sector, for example, the following are illustrative:

Reforestation & Watershed Management: All major components of this project are directed at upgrading the general technical forestry knowledge of the Forest Department. The resulting institutional strengthening will be amalgamated with research equipment procured under this project in order to support the Forest Department's desires to carry out indigenous forest products research. The technology transfer element of this project will allow the Forest Department to undertake basic research which it is currently unable to do, and will allow the Department to play a leading role in reforestation, fuelwood and further forestry sector development in Sri Lanka.

Rice Research: The focus of this project is the transfer of new production technology for rice to the Department of Agriculture. The project has introduced and etablished new production and cropping systems research for the highly variable growing zones in Sri Lanka, and strengthened the rice research stations located in these zones. Some of the technology, training and commodities will also be useful in increasing the production of subsidiary crops. During 1982, five Sri Lankan scientists working under this project were recipients of the first ever Presidential Award for Science.

Diversified Agriculture Research, Production and Marketing: This project will concentrate on improved technologies for subsidiary food crops production. Research emphases will include screening and breeding for higher yields, disease resistance and stress tolerance, soil fertility, and soil and water conservation.

An additional component of the project will focus on market development through alternative and improved processing technologies for multi-use commodities.

Under the Development Services and Training project, the USAID has financed smaller activities for transferring technology which have had a development impact far greater than the limited costs to AID. A couple of notable examples follow.

Using the basic design of a handpump developed by Georgia Tech and technical assistance from this institution, the USAID supported the local construction and testing of handpumps for use in Sri Lanka's rural sector. A small private sector industry has been created and the cost of providing water to the rural population substantially reduced. The Ministry of Local Government, Housing and Construction has endorsed this handpump for use throughout Sri Lanka because:

(1) the private sector manufacturer is producing a high quality product appropriate to the country; and

(2) the local manufacture of the pump offers benefits not available through imports (e.g., lower cost, readily available spare parts, in-country employment generation, and reduced foreign exchange requirements).

Under a follow-on project, the USAID plans to use a greater proportion of funds to support private sector technology transfer activities of a small-scale and/or experimental nature. In addition, we will give greater attention to ensuring that U.S. investors supported by AID provide appropriate training and

technology to Sri Lankan joint venture partners.

Examples of areas where modest AID funding for pilot efforts are possible include:

(1) use of animal power, alone and in combination with mechanical power, in the Dry Zone;

(2) use of fuel-saving cooking stoves; and

(3) experimentation with mini-hydro and other alternative energy sources.

USAID will continue to assist the GSL to maintain continued close collaboration with the International Rice Research Institute, and to further strengthen its relationship with other key institutions like the International Crops Research Institute for the Semi-Arid Tropics (ICRISAT), the International Institute of Tropical Agriculture (IITA), and the International Food Policy Research Institute (IFPRI).

The USAID will continue to participate in the Office of the Science Advisor's program in Innovative Research and Scientific Capacity Building for Development. We will continue to actively encourage Sri Lankan scientists to submit relevant research proposals under this program. An emphasis will be given to proposals dealing with problems in the agriculture sector. We will also remain sensitive to opportunities to expand the access of Sri Lankan institutions to relevant programs of the Bureau for Science and Technology.

3. Goals

By 1988, AID's contributions will have assisted in:

(1) the Forest Department having the capability of carrying out needed forestry and forest products research, as well as, using appropriate technology for its reforestation and fuelwood activities;

(2) Sri Lanka having a self-sustaining rice research capability;

(3) the establishment of adequate research facilities and staff to make a meaningful contribution to increased production of subsidiary crops;

(4) greater stress within the AID program on research and the development of appropriate technology;

(5) the more direct linkage of AID-supported pilot efforts to the private sector, and the expansion of its technological and research capabilities;

(6) the strengthening of Sri Lankan institutional capabilities to identify and apply appropriate technologies;

(7) the carrying out of experimentation in non-traditional energy sources which can feed into our policy dialogue on energy;

(8) the expansion of collaboration between Sri Lankan and relevant international and regional research institutions;

(9) in the case of U.S. private investment, giving greater attention to ensuring the provision of appropriate training and technology for Sri Lankan partners; and

(10) the continuation of support to expand the access of Sri Lankan institutions to the programs of AID's Bureau for Science and Technology and Science Advisor.

D. Institutional Development and Participant Training

1. The Sri Lanka Setting

Sri Lanka is fortunate in having a highly literate population. Approximately 94% of school-age children are enrolled in primary school, while 51% of those in the secondary school age group attend high school. Opportunities for higher learning, however, have not kept pace with expanding primary and secondary school output. Currently, the country's university system is able to absorb only 18% of those who meet admission requirements. Even university graduates, however, usually require additional vocational or technical training in order to be employable. This situation, plus migration, has contributed to serious shortages of professionals such as doctors, engineers, and mid-level managers. Concurrently, Sri Lanka is experiencing critical shortages of skilled labor such as technicians, carpenters, masons, mechanics and electricians. Migration of Sri Lankans to the Middle East is increasing as the wages there are many times higher. Estimates are that there are now 150,000 Sri Lankans in the Middle East of which 7% are mid-level managers, 39% skilled and 54% semi-skilled workers. This number may double by 1985. While growing remittances from these migrants have certainly helped the balance of payments, Sri Lanka has suffered from their absence.

Although the GSL and private sectors have undertaken efforts to increase technical training facilities and programs and apprenticeship programs, a much greater effort is required to improve the implementation and effectiveness of the country's

current and future development efforts, including those supported by AID. Our experience has been that, although the top administrative leadership within the GSL is excellent, the quality and numbers of staff at the mid-management, administrative and technical levels, while varying significantly among ministries, tends to be in short supply.

There is evidence that the role of the public sector as a major employer in Sri Lanka is changing. Prior to 1977, the public sector played a major role in creating employment opportunities, especially in state corporations. More recently, the GSL reports that the intake of job seekers into public sector employment has slowed down. This is mainly due to the GSL's policy of encouraging the private sector to more fully participate in the economic development of the country. Over the CDSS period, the private sector is expected to play a major role in creating more employment opportunities.

2. AID's Efforts to Strengthen Institutional Development and Participant Training

Under its ongoing program, the USAID has undertaken significant efforts to strengthen Sri Lankan institutional capabilities. In the key agricultural, health/population, and private sectors these efforts have included:

(1) National Agriculture, Food and Nutrition Strategy: Support to development and implementation of an integrated strategy will assist the GSL to analyze its agricultural resources, establish priorities, identify and resolve constraints,

allocate resources, and identify investment opportunities.

(2) The Information Center at the Agrarian Research and Training Institute (ARTI): When developed, the Center will serve as a repository of agricultural data and information, and will assist: (a) researchers in minimizing duplicative research and shortening the time to attain results; (b) policy makers in the design of more relevant agricultural and rural development policies; and (c) program/project designers and implementors with more relevant information, leading to better designed activities, implemented with the benefit of lessons learned elsewhere.

(3) The Market Research Unit at ARTI: This Unit will provide GSL policy makers and private entrepreneurs with timely, quality market data and undertake specific market research activities.

(4) Agricultural Education Development: This project was designed to support the development of the Post Graduate Institute of Agriculture. The basic thrust of this project is to assist in establishing the institution and developing its capacity so that it can respond to the needs of Sri Lanka in agricultural education. Future assistance will be directed to new undergraduate agricultural schools geographically located to meet the increasing demand for agriculturalists.

(5) Water Management: Under the present Water Management project, the USAID is helping the Irrigation Department to establish a new Office of Water Management. A key element of this project is the establishment of the Institutional Organizer

Program which is training personnel who will help establish Water User Associations in irrigation systems. In the USAID's planned Irrigation Sector Project this element will be expanded and a separate Operations and Maintenance Division within the Irrigation Department will be established. The indigenous institutions associated with the Mahaweli Development Program are also being helped through training, construction of facilities, and the development of new and existing cadres.

(6) National Water Supply and Drainage Board (NWSDB): An U.S. contractor is working with the NWSDB to improve its capabilities to perform master planning, feasibility studies, and the design of low cost water supply systems. The contractor is also working with the NWSDB in developing and implementing training courses for public health inspectors, engineering assistants, technical assistants, technicians and analysts in public health matters related to safe drinking water and sanitation practices; public health midwives in the field of public health; laboratory medical technologists in water analysis; workers and masons in appropriate technology for the construction and use of safe drinking water and excreta disposal facilities; and operators and maintenance personnel for operating water supply and sanitation facilities. The capability for testing and enforcement of water quality is being upgraded by the construction, equipping and staffing of laboratory facilities in the Jaffna District.

(7) Private Enterprise Promotion: The primary thrust of the USAID's private enterprise initiative is the development of

local capabilities and capacities to carry on the development of the private sector. To this end, the USAID will work with public sector officials to institutionalize a capability to conduct ongoing assessments of the private sector and the preparation of critical analyses of various policy and selective incentive options. We will assist in the establishment of a local Investment Promotion Center with the objective of its becoming self-sustaining through fees for its services, as well as outside contributions from its beneficiaries.

The USAID also will be assisting various financial market institutions to formulate constructive investment programs and technical assistance resource pools that would be supplied on a reimbursable basis. The key institutions engaged in management training and entrepreneur development will be strengthened and their programs tailored to meet the needs of the private sector.

In addition to the above, the USAID has supported U.S. and indigenous private voluntary organizations (PVOs) under its PVO Co-Financing project and population activities. In line with the GSL's policy of encouragement of broader private sector participation in the country's development, PVOs are becoming increasingly involved in development projects, especially those focussed on the rural sector. AID will continue to support PVO activities, including those with broad-based participation, directed towards increasing the role of women in development, and linked to the private sector. For example, the USAID, in collaboration with the Asia Foundation and the Sri Lanka Chamber of

Small Industries, will support a program of entrepreneur skills training. Increasing numbers of Sri Lankans who have returned from employment in the Middle East and Africa with savings have shown interest in starting small-scale firms, but have lacked requisite knowledge and the skills. The Sri Lanka Chamber of Small Industries will provide these new entrepreneurs with the necessary skills and pactical training.

Over the CDSS period, the USAID plans to increase its already significant participant training program and to focus it more specifically on: (1) management/administrative training in the public and, to an increasing extent, private sectors; (2) technical training in fields related to USAID's priority sectors; and (3) training of trainers as a means to enhance and expand indigenous (and increasingly private sector) training capability. The major share of participant training will continue to be funded through USAID projects. However, we also contemplate utilizing a greater portion of Development Services and Training (DS&T) funds, under the current and follow-on project, for participant training. This provides a flexible mechanism for carefully targeted management and technical training and will be utilized to upgrade capabilities in areas in which the USAID intends to work. As an example, DS&T funds will be used for more training in health population and nutrition, a new sphere of USAID concern and one which parallels the GSL's renewed interest in social equity issues. In general, participant training will emphasize:

(1) specialized academic training, with less degree

training, especially at the Ph.D level, except in a few highly specialized areas;

(2) management/administrative training for technical personnel who find themselves in more senior administrative positions, but without the necessary management skills;

(3) training for key personnel in local training institutions such as ARTI and the Sri Lanka Institute of Development Administration; and

(4) more technical and management training for women in line with a GSL decision to encourage the participation of women at increasingly higher levels of government.

Increasing numbers of those from the private sector - in banking, business, finance - will also be sought as candidates for USAID-funded training.

3. Goals

By 1988, we expect:

(1) a Sri Lankan capability will be in place to generate and analyse agricultural data in a rational manner for use by policy makers;

(2) the agricultural policy and planning capabilties of the GSL will have been strengthened;

(3) the undergraduate and graduate agricultural education system in Sri Lanka will be capable of producing the needed quantity and quality of graduates;

(4) GSL agencies involved in the irrigation sub-sector will have institutionalized farmer organization,

operations and maintenance, and cost recovery principles in their efforts;

(5) the linkages between water and sanitation systems construction, health education, community involvement, and user fees will be strengthened, and investments in these systems rationalized;

(6) the public and private sector capacities to conduct managerial training and entrepreneurial development activities on a self-sustaining basis will be in place;

(7) the role of PVOs in development activities will be expanded, and PVO capabilities improved;

(8) our increased support for management and administrative training will result in more effective decision making and resource allocations;

(9) through the training of trainers, the capabilities of private and public institutions will be increased;

(10) the AID program will support increased in-sevice technical and managerial training, with the bulk of degree training being carried out in Sri Lanka.

E. Food Aid as a Development Tool

The PL 480 program in Sri Lanka consists of both Title I and II. It is considered an integral part of the program strategy for it provides quick-disbursing aid which assists the GSL to meet its food and nutrition needs, a continuing balance of payments problem and budgetary deficits. It also selectively supports USAID priorities in agriculture and health.

1. Title I

The United States has been a principal source of food aid to Sri Lanka since 1956. At the end of FY 1982, the value of food assistance to Sri Lanka totalled approximately $300 million. As a proportion of Sri Lanka's total annual food aid, PL 480 Title I program represents about 60% and in terms of total U.S. economic assistance about 25%.

The Title I program was the subject of an Impact Evaluation carried out in March 1982. The final evaluation report contains several important conclusions and recommendations which are noted below.

- The Title I program represented a significant positive balance of payments resource.

- The program made a positive contribution to U.S.-Sri Lanka relations.

- The provision of wheat under the program may have positively affected food consumption of low income groups by freeing rice supplies for rural families.

- Sri Lanka has been unusually successful in addressing both the consumer and producer pricing objectives of food policy, especially for rice.

- Since 1977, private sector dominance in rice purchases at the farmgate and in grain/flour/bread marketing has had a positive impact on production and probably improved distribution to consumers.

- Nutritional status in Sri Lanka is better than average

for countries at similar per capita GNP levels, although about 3% of children continue to be chronically malnourished.

- Because Sri Lanka was generally pursuing sound rural development strategies independent of Title I, the PL 480 funds were relatively minor in relation to the GSL's total budget to the rural sector.

- An innovative arrangement that incorporates a multi-year commitment of food aid but does not involve the considerable administrative costs associated with Title III needs to be explored.

Sri Lanka's 1982 rice harvest was seriously reduced by the most serious drought to hit the country since at least 1974. Total production is estimated to be 2.1 million metric tons, 9% below production in 1981. Substantial reductions in tea, coconut and subsidiary crops production have also resulted from this drought. The GSL has needed to import 200,000 metric tons of rice, the estimated cost of which was about $50 million. The balance of payments and budget deficit ramifications due to drought-necessitated imports and drought assistance measures in 1982 were significant. Although the GSL has indicated its continued commitment to maintain manageable budget deficits and balance of payments situation, additional pressures will continue to be felt by the economy over the next several years.

The USAID believes it has established meaningful self-help measures for the recent Title I agreements. The core measure is for the GSL to prepare a national agriculture/food/nutrition

strategy and estimates of domestic and external resources required for its implementation. The USAID views the development of this strategy to be a key to not only the future direction of the country's agricultural sector, but also the basis for new directions of future AID assistance. We believe the evaluation recommendation to explore a multi-year Title I agreement has merit and intend to pursue this in the context of the FY 1985 program by which time it is expected that the strategy will be completed and approved by the GSL, and investment decisions made for implementation in 1985. AID's assistance to the development of the strategy and the linkage of our future agricultural sector program to this strategy will result in the tight integration of Title I food aid and development assistance projects.

The Title I program is currently integrated with the development assistance program through self-help measures to study agricultural policies and marketing systems and conduct cropping and farming systems research in dryland areas. These efforts will be pivotal to the successful design of our Diversified Agriculture Research, Production and Marketing project.

The local currency generated under the Title I program is used to support GSL expenditures in several areas closely related to AID's development assistance program including irrigation and water management; agricultural production, extension and research; integrated rural development; improvements to and expansion of fertilizer and grain storage; and reforestation and land and water conservation. This close relationship will be extended further as

the strategy and related investment decisions progress over the next few years.

The USAID believes the Title I program has been successful in supporting the sound agricultural policies of the GSL, relieving serious balance of payments problems and helping to fill a food gap. The Title I program is integrated with the development assistance program and we will strengthen this integration. While the GSL has shown its strong determination to reach rice self-sufficiency and food self-reliance, it will continue for the foreseeable future to require concessional food aid, of which Title I should be an integral part.

2. Title II

The FY 1982 team which evaluated Title II activities in Sri Lanka was favorably impressed with CARE's administration of both the Thriposha and the school-feeding programs. CARE is also channeling food to other PVOs operating in Sri Lanka such as Save the Children Federation, Sarvodaya, and the Mahila Samiti (a women's organization), all of which have received development assistance from AID.

Thriposha, which is made from U.S. donated Instant Corn Soya Milk (ICSM) and soya and maize donated by the GSL, is distributed primarily through the health clinic system in a maternal/child health (MCH) program. Vegetable oil and 12% soya fortified flour are used in the production of biscuits which are distributed through a feeding program in the primary school system.

With respect to the MCH program, the USAID intends to

support a CARE proposal to expand the processing capability of the Thriposha plant from the FY 1982 level of 4,680 metric tons of Corn Soya Blend to a level of 19,600 metric tons in 1985. The expansion of facilities would eventually permit the GSL to produce Thriposha with 100% indigenous grains and enable the GSL to go island-wide with the commercial program. The Ministry of Health (MOH) is presently studying the long-term cost implications of the proposed expansion.

The USAID expects the present formulation used in the production process of Thriposha (40% locally grown maize and soyabeans and 60% (ICSM)) to remain the same through FY 1984, i.e., until the installation of new processing equipment is completed, after which U.S. donated commodities could gradually be replaced with indigenous cereals. Even if the MOH decides not to expand the existing facilities, the USAID would consider beginning a gradual phase-out of U.S. commodity imports in FY 1985. At this time, however, the USAID is continuing to retain the AID/Washington approved recipient levels, thus the dollar value of the Thriposha program remains straight-lined for the FY 1985-88 period.

The experimental commercial program has shown that Thriposha is a competitive product with high consumer acceptability. About half of the purchasers in one study had monthly incomes of Rs.300 or less, indicating that the commercial product is also reaching poorer families. The Title II evaluation team recommended initiation of a regular commercial program, provided that it does not jeopardize supplies for the

maternal/child health feeding program. CARE also believes that Thriposha presents a feasible opportunity for Sri Lanka to have a low-cost indigenous weaning food priced well below currently available commercial products. However, until Thriposha production capacity is expanded, it will not be possible to promote commercial sales on a large scale.

With the installation of additional processing equipment, the formula of Thriposha for the commercial market can be composed of 100% indigenous ingredients without affecting production of Thriposha for the MCH program. On the assumption that increased production capacity will not be available until 1985, CARE and the USAID will continue low-level Title II support for the program through 1984, so that the existing markets for the product will not be interrupted. No further U.S. commodity support is anticipated thereafter.

Subsequent to the February 1982 evaluation of the Title II program and in preparation for the 1984 ABS submission, CARE discussed the school feeding program with the Ministry of Educational Services. The Ministry has accepted, in principle, the development of a long-range plan for school feeding with a substantial increase in GSL inputs. Beginning in FY 1983, the GSL proposes to extend its school feeding program to all primary schools not presently included in the program. At the same time, children in grades four and five will no longer be eligible to receive the biscuits. This change in the program will have the effect of targetting these scarce food resources on a younger, more

vulnerable, age group generally considered to be more in need of a food supplement. In order to allow the GSL time to implement the re-targetting of recipients and to budget for a gradual take over of the entire program, AID will continue support for a recipient level of 1,000,000 primary school children through FY 1984 after which AID commodity inputs will be phased out at a rate of 25% a year.

3. Goals

By 1988, we expect:

(1) a multi-year Title I program linked to the agriculture, food, and nutrition strategy and public investment program will be ongoing and local currency proceeds will be fully integrated with the strategy and investment program and the AID program; and

(2) under the Title II program, Sri Lanka will have assumed full responsibility for the school feeding program and the AID input into the maternal/child health program will be in the process of being phased-out as indigenous commodities replace those provided by the U.S.

III. AID Assistance Strategy and Program

A. Continued Validity of the Strategy

The USAID fully supports AID's emphasis on the basic development tools discussed in Section II. Our planned efforts in these areas are fully discussed therein.

Our strategy which remains valid will intensify the use of all these tools in a mutually reinforcing way. The recent return of the UNP government to office confirms that the GSL policies and strategies, upon which the USAID strategy is based, will continue over the CDSS period.

The USAID will continue with the CDSS objectives of expanding food production, increasing employment generation and incomes, and improving human productivity and well-being. Through this strategy, the USAID can directly support the GSL's key development objectives of economic growth and increased employment, while also helping to maintain the well-being of the Sri Lankan people, especially the poor who are most vulnerable to the short term dislocations caused by economic growth and inflation.

We have indicated for each category of assistance the basic goals which we believe to be attainable by 1988. The goals can be attained through a synthesis of GSL policies, programs and projects funded by the USAID and other donors. However, we have limited discussion of these goals to areas of prime interest to the USAID, though often jointly funded.

During the CDSS period, the heavy construction costs of the Mahaweli program will be phasing down and out as the large dams and

major irrigation infrastructure are completed. These elements of the program have absorbed 40% of the GSL's development budget.

While there will continue to be a strong emphasis in downstream settlement and productive aspects of the Mahaweli program, required resources will be much less than for the current program. Thus, both GSL and AID resources will be increasingly allocated for social infrastructure and other productive elements of the GSL program. GSL policies for this period include a greater emphasis on quality of life, including rationalization of the health and education sectors, a continuing emphasis on agricultural development and employment generation, and increasing attention to long-term strategies for energy and the environment. GSL policies will also promote an increasing role for the private sector in the overall economic development program.

Our approved strategy, as summarized below, has been refined to reflect not only GSL policy and resource shifts, but basic policy statements prepared by AID/Washington over the past two years. The USAID will increase our efforts, both in ongoing and future assistance, to enhance the role of the private sector in Sri Lanka's development. In addition, increased attention will be given to strengthening the analytic, planning, implementation and management capabilies of Sri Lankan public and private institutions which will play key implementing and support roles to future AID-assisted efforts.

The Strategy will concentrate support in priority sectors of the GSL's Public Investment Program, where additional assistance is

needed and where AID has both a legislative mandate and comparative advantage.

B. Future Directions and Goals

1. Modes of Assistance

The USAID will continue to utilize the sector approach in areas where: (1) the GSL has institutional capacity to implement it; and (2) the GSL has or is developing a national strategy. The sector approach is a flexible instrument which allows the USAID to influence and to react quickly to GSL policy changes. Areas where the USAID believes the sector mode is appropriate include Mahaweli downstream development, irrigation and selected preventive health interventions (including water supply and sanitation and malaria control activities).

The USAID will continue to provide technical assistance to the GSL in the development of strategies and comprehensive investment plans, and for the improvement of institutional capacity to carry out such plans. Priority will be given where the USAID is considering future program investments such as agriculture, private sector development, and preventive health. However, the USAID also intends to give favorable consideration to areas such as energy, the environment and transportation where AID will not have a large involvement, but clearly has a comparative advantage and where a relatively small technical input in strategy or planning development has the potential to eliminate constraints to Sri Lanka's economic development. This is a means of leveraging relatively small amounts of AID funding to encourage follow-on

investments from other donors and, we expect, the U.S. private sector.

The USAID will provide project assistance where:

(1) the technical requirements are high and detailed AID monitoring is required (e.g., Diversified Agricultural Research, Production and Marketing);

(2) the purpose of assistance is institution building (e.g., Agricultural Education); or

(3) it is more effective for the USAID to manage or be significantly involved in the management of the assistance (e.g., training and small demonstration or pilot activities).

2. Assistance Categories

We will maintain a consolidation of our assistance into three general categories:

(1) Accelerated Mahaweli Basin development;

(2) food production and natural resource management; and

(3) human productivity and well-being.

As the major construction in the Mahaweli Development Program begins to taper down, USAID's strategy will reflect a shift of resources to the food production and natural resource management, and human productivity and well-being categories. However, there will continue to be a critical need for U.S. assistance in support of the Mahaweli Program during the CDSS period. Such assistance will focus on the agricultural support and social infrastructure required to bring the agricultural production and income benefits to farm families in the Program area.

a. Accelerated Mahaweli Basin Develoopment

The Accelerated Mahaweli Program (AMP) continues to be the GSL's highest priority. It is considered a key to the country's primary objectives of food self-sufficiency and employment. It is supported by the World Bank and a host of other donors, and is the largest single investment of the USAID. In addition to its food production and emoloyment benefits, the AMP will also provide land for poor, landless farmers and produce substantial hydro-electric power. By 1988, the program will bring 117,00 hectares under production, resulting in the settlement of more than 450,000 people, increase domestic rice production by 547,000 tons per year, provide emoloyment - direct and indirect - for up to 175,000 people, and generate 500 megawatts of hydro-electric power.

AID's direct involvement is in System B. System B represents the largest land area under the AMP. When fully developed, it will provide irrigated agriculture for small farms totalling 37,400 hectares of primarily paddy land and 17,680 hectares of homestead owned by 43,000 voluntary settlers selected from rural districts throughout Sri Lanka. We expect that by 1988 20,000 families will have been settled on the left bank (where AID is financing the irrigtion infrastructure) and the necessary social and agricultural infrastructure (schools, clinics, extension centers, farm-to-market roads, etc.) will be in place. Approximately 52,000 additional metric tons of paddy and 2,100 metric tons of subsidiary crops will be produced annually.

AID will also complete assistance in the related critical area

of environmental protection for the Mahaweli area. By 1988, four national reserves should be in place, surrounding the settlement areas, and wildlife relocated from the settlement areas into the reserves.

AID is also providing, under the Mahaweli Sector Support loan, the means for the GSL to maintain adequate levels of local currency investments in the AMP, specifically downstream efforts required to support resettlement such as basic roads, schools and related social infrastructure. This loan reimburses the GSL through an unrestricted special letter of credit which is used to finance imports from the U.S.

The USAID and GSL believe the adequacy of settler support, including social and agricultural services is critical to the success of the AMP. The USAID will intensify assistance during the CDSS period to ensure their provision. The USAID will also press for the incorporation of lessons learned from earlier AID projects such as Mahaweli Ganga Irrigation (in System H), Rice Research and Water Management into the System B undertaking. With encouragement from the USAID, the Accelerated Mahaweli Program has seen significant policy changes by the GSL which have resulted in increased participation by the U.S. and Sri Lankan private sectors in the program and increased efforts to implement efficient water management, including water user charges.

In addition, USAID will work closely with the GSL authorities to delineate further settlement areas which could use Mahaweli waters. Such feasibility analyses will assist the GSL in

development of strategies for increased availabilities of land for settling the unemployed and landless.

During the CDSS period, $95 million in AID resources will be in support of the Accelerated Mahaweli Program. This reflects a level of assistance quite close to that in last year's CDSS.

b. Food Production and Natural Resource Management

Assistance in this category will be concentrated on improving irrigation and water management in smaller systems outside the Mahaweli program area; expanding research, food production and improving marketing for subsidiary crops grown under rainfed conditions; and protecting Sri Lanka's dwindling forest and soil resources, expanding alternative energy resources (including fuelwood and mini-hydro), and environmental enchancement.

Under this assistance category, the USAID is concentrating on four program areas:

(1) irrigation and water management;

(2) diversified agriculture research, production and marketing;

(3) agricultural policy and planning; and

(4) alternative energy resources and environmental enhancement.

During the CDSS period, an estimated $218 million will be provided to this category through development assistance ($93 million) and PL 480, Title I support ($125 million). As contrasted to last year's CDSS, this reflects increased development assistance

to diversified agriculture, agricultural policy and planning, and alternative energy resources and environmental enhancement. Title I support reflects a straight-lining for the CDSS period.

(1) Irrigation and Water Management

This program area will continue to be a major focus of USAID assistance over the CDSS period. While major funding and donor assistance are needed to help rehabilitate many of the irrigation systems in Sri Lanka, the USAID's proposed assistance will also focus on the "software" aspects of irrigation, including the greater efficiency of water use, farmer participation, and systems operations and maintenance. This effort will build on the experience being gained under the current Water Management project and our institution building efforts with the Irrigation Department and other organizations involved in this sub-sector. Particular emphasis will be placed on better training to improve system operations and other institutional aspects, including the establishment of viable farmer organizations. The World Bank is already planning to draw upon the training and farmer organization aspects of AID's Water Management project for an upcoming irrigation rehabilitation project. The GSL is to implement a new Water Resources Act and an amended Irrigation Act which are expected to be passed by mid-1983. The significance of the proposed Water Resources Act is that it provides "umbrella" legislation setting forth a national water policy calling for the comprehensive and coordinated use of water and related resources by the GSL and water users. The amended Irrigation Act is to focus on

the allocation, distribution, use and management of water in all major irrigation schemes.

Future USAID assistance in this program area will flow from an evaluation of the Water Management project and an irrigation sector survey which were carried out jointly by the GSL and AID in 1982. These recommended continued AID support for rehabilitation efforts in Gal Oya, and for the expansion of in-country training and farmer organization activities.

By 1988 we expect:

(1) a Water Management Unit within the ministry responsible for irrigation to be structured and staffed to provide country-wide guidance and support on effective water management;

(2) systems and procedures will be developed and in place for cost-effective rehabilitation of irrigation system;

(3) the Gal Oya irrigation system will be fully rehabilitated and utilizing effective water management techniques;

(4) effective O&M systems will be in place on a country-wide basis, with increased farmer participation; and

(5) nine irrigation systems will be rehabilitated and improved water management practices instituted to allow full agricultural production.

(2) Diversified Agriculture Research, Production and Marketing

Increased production of subsidiary field crops in the dry and intermediate zones of Sri Lanka is one of the highest priorities of both the USAID and GSL. It is an area of significant, largely

untapped agricultural potential and poorest elements of the population. The crops under consideration (coarse grains, legumes and oil seeds) are both nutritionally important and tend to have a wide range of potential uses - an important consideration for agro-industrial development. The GSL attaches particularly high importance to these crops in its efforts to increase incomes and provide adequate nutrition, as well as to initiate more effective land use planning.

This area constitutes a logical progession in USAID's assistance from the earlier emphasis (paralleling that of the GSL) on rice production. The work will be relevant to most farmers in these zones, as nearly all of them, whether inside or outside the command of the major irrigation schemes, undertake some unirrigated upland farming. Furthermore, it will complement the on-going USAID investment in the Mahaweli program by its emphasis on improved technologies for those significant portions of the Mahaweli areas more suited to such crops. Development of this project will parallel development of the GSL's National Agriculture, Food and Nutrition Strategy (NAFNS) exercise, now scheduled for completion by mid-1984, and will be designed for phased implementation, permitting subsequent accommodation of NAFNS findings and recommendations.

The USAID's involvement in this area will result in increased farm incomes, improved nutrition through increased consumption of protein-rich legumes and overall increased food availability; expanded employment, both on-farm and in agriculture-related

activities (eg., marketing); and improved land resource management through sustained-yield farming on the cultivable uplands.

By the end of the CDSS period, we expect:

(1) five research stations will be equipped and staffed for applied research in selected subsidiary crops;

(2) private sector seed production units will be established and providing certified seed for approximately 10% of the annual seed requirements for subsidiary crops;

(3) a 90% increase in the production of subsidiary crops;

(4) a functioning extension service will be in place to transfer research results to the farmers; and

(5) an adequate marketing system will be in effect.

(3) Agricultural Policy and Planning

The GSL is aware of the problems imposed by the large number of overlapping government agencies with food and agriculture responsibilities. For example, the collection of economic data and market intelligence is widely dispersed. As a result, reliability of data is poor and systematic analysis of data is seldom carried out. Key information on crop prospects, domestic supplies, consumption and import commitments are frequently too late to be fully useful. Despite the substantial amount of data collected by different entities there are major gaps which seriously inhibit planning, farmer operations, and agribusiness serving farmers. The GSL needs more accurate, comprehensive and timely data and analysis upon which to make decisions. The National Food Policy Committee (NFPC) which includes representatives from the prinicpal ministries

concerned with food production and consumption was created in 1979 to improve planning and coordination. The Marketing Research Unit (MRU) has been set up in the Agrarian Research and Training Institute to provide data and analysis to the NFPC. The USAID is currently assisting in strengthening the institutional capability of the MRU. However, substantial improvements are still needed in data collection, analysis and dissemination, and in managerial and technical training to strengthen the country's agricultural policy and planning capabilities.

Building upon our ongoing assistance to the agriculture, food and nutrition strategy and to MRU, the USAID will consider follow-on support to strengthen the GSL's policy and planning capabilities.

We expect that following the completion of our assistance, systems will be in place for:

(1) the constant review and refinement of the strategy; and

(2) the collection, analysis, and dissemination of both production and marketing data.

We expect that by 1988, the implementation of the strategy will have had a substantial impact on agricultural production. However, such impact cannot logically be predicted until the strategy has been completed.

(4) Alternative Energy Resources and Environmental Enhancement

Fuelwood is by far the most important source of energy in Sri

Lanka, accounting for 60% of total energy used in 1980. Most of this energy, which is used in the rural domestic sector for cooking, comes from village woodlots, rubber replantation and indiscriminate forest destruction. Therefore, apart from its significance as a source of energy for rural people, fuelwood has significant environmental implications. The provision of fuelwood in adequate quantities to meet the increasing demands of the rural sector, while maintaining an environmentally acceptable forest cover, is judged to be Sri Lanka's most important energy problem.

Forest lands covered 44% of Sri Lanka's total land area in 1956. By 1976, the country's forest cover had been cut in half to 22% (3.5 million acres). If the present estimated rate of deforestation were to remain constant, Sri Lanka would be denuded of all its reamining forest cover in less than 30 years.

The depletion of Sri Lanka's forests has also created severe shortages of fuelwood required to meet the rural population's domestic energy requirements. Over 94% of Sri Lanka's rural population use firewood for cooking.Given the increasing prices of oil and kerosene, the demand for fuelwood has increased dramatically, especially in the rural sector.

The AID-supported Mahaweli Environmental Assessment concluded that, in the upper catchment, annual soil losses range from .3 to 7 metric tons per hectare on well managed land. On poorly managed land, the losses range from 21 to 570 metric tons per hectare. Annual aggregate soil loss from mapped portions of the catchment is estimated to be 11.3 million tons per year. This is the equivalent

of a 4,800 hectare annual productivity loss.

The protection of the watershed areas (including the upper Mahaweli catchment area) and the provision of increased sources of fuelwood are mandatory for increases in agriculture production and the improvement of rural incomes.

Under the existing Reforestation and Watershed Management project, the USAID is supporting reforestation and the establishment of fuelwood plots. In addition, AID is strengthening the capability of the Forest Department to plan and implement expanded national forestry programs. Building upon this current effort, the USAID will provide additional assistance in this area, with an emphasis on soil stabilization and watershed management.

In addition, the USAID will give increased attention to assisting the GSL in the development of energy policies and plans. We will also support research and pilot efforts involving mini-hydro and other alternative energy sources.

By 1988, we expect:

(1) the forestry master plan to be completed and in process of implementation;

(2) the Forest Department will have the capacity to plant 35,000 acres annually and the organization and staff necessary to protect existing and newly-planted forests;

(3) China Bay Forestry College will have the capacity to graduate 45 forest guards and rangers annually;

(4) the university-level undergraduate forestry program will be fully established.

(5) overall GSL energy policies and plans will be completed;

(6) determination of cost effective renewable energy technologies and pilot testing will be completed; and

(7) replication of suitable technologies will be in process, with a large private sector involvement.

c. Human Productivity and Well-Being

The GSL's redirection of resources to investment over the past five years has resulted in a decline in the quality and quantity of social services, which has been especially felt by low income families. This is to be expected in a period of vibrant economic growth with its attendant dislocations. However, the GSL is concerned that every possible effort be made to reduce hardships until the full benefits of growth are attained and to maintain the excellent human resource base necessary for sustained economic growth. Thus, for the 1982-86 period, the Public Investment Program increases investments on social overheads to over 13% (over $590 million) of the total Program, up from 9% in the 1981-85 Program. The USAID will target assistance to help low income families to maintain an adequate level of health and, in turn, level of productivity. Under this assistance category, the USAID will concentrate on:

(1) health, population and nutrition;

(2) low income housing guarantees; and

(3) education and training;

During the CDSS period, $104.7 million in development assistance

and PL 480, Title II, commodities, plus housing guarantees of $125 million will be provided. This reflects about a 20% decrease from the levels of development assistance and Title II proposed in last year's CDSS.

(1) Health, Population and Nutrition

While Sri Lanka's social gains over the past 30 years have been impressive and appear better than in many developing countries, there are still significant problems. Examples include reported malaria cases of close to 40,000 per annum, 40% of hospital admissions due to waterborne diseases, and an infant mortality rate in some districts as high as 76 per 1,000. Less than 10% of the population have access to adequate potable water and sanitation facilities. It is clear that increased attention is needed in these areas.

Although the GSL's policies of providing "free" health care have resulted in significant health gains, selected mortality and morbidity rates remain high and the GSL is faced with increasing health care costs. Among the major contributing factors to the seriousness of health problems are insufficient primary health services at the village level, a lack of emphasis on preventive health care, high fertility, malnutrition, and the lack of clean drinking water and sanitation facilities.

In 1980, the GSL (with assistance from the World Health Organization) began work on a plan to reorganize and restructure its health care system. The completed plan calls for a shift in emphasis away from curative health care towards preventive health

services and an extension of health services down to the community/village level. In 1980, the GSL, with AID support, also developed a national water supply and sanitation plan for the International Drinking Water Supply and Sanitation Decade (1981-1990). The implementation of these two plans will require considerable institutional development including significant donor support for technical assistance, training, commodities and capital costs.

In this area, which will build on our current efforts, the USAID currently is considering possible assistance to the GSL to:

(1) support the efforts to restructure and improve primary health care services;

(2) support the National Water Supply and Drainage Board in implementing selective aspects of the Sri Lankan plan for the Drinking Water Supply and Sanitation Decade; and

(3) continue the Anti-Malaria Campaign.

To reduce the population growth rate, the current GSL policy is to promote temporary family planning methods primarily through private voluntary organizations with the GSL primarily providing services for voluntary sterilization. The sterilization program has been rather successful, but the use of effective spacing or temporary methods does not appear to be increasing, while traditional method usage is increasing rapidly. With a natural rate of population increase of about 2.1%, additional efforts are required. The USAID will continue to support population requests through centrally-funded U.S. intermediaries

and through our Development Services and Training and PVO Co-Financing projects. We will also stress the need for expansion of family planning information and services in the primary health care program.

The detailed program which the USAID decides to undertake in the health and population sectors will be based upon the results of an upcoming AID/World Bank/GSL strategy exercise. The results are expected by mid-1983, and will include the identification of donor interventions and the cost effectiveness of the GSL's future health and population investments.

In the case of both the maternal child health (MCH) and school feeding programs under Title II plans currently call for the GSL gradually to take over responsibility for these. Under the MCH program, we see a gradual phase-out beginning in FY 1985 as an expanded processing capacity will permit the increasing use of indigenous in lieu of U.S. commodities for the program. In order to allow the GSL time to implement improved re-targetting of recipients and to budget for a gradual take over of the school feeding program, we will to continue support for a recipient level of one million primary school children through FY 1984 after which AID commodity inputs will be phased out at a rate of 25% a year.

By 1988 we expect that:

(1) A primary health care system will be operational throughout much of the country with multi-donor support;

(2) the National Institute of Health Sciences for training para-medical personnel will be equipped and staffed to

supply a significant share the country's needs for such personnel;

(3) the MCH program will be increased to 650,000 recipients, but with a much larger proportion of inputs from indigenous resources;

(4) a self-sustaining school feeding program using indigenous foods will be place in the poorer districts;

(5) the institutional capacity for designing implementing and managing potable water systems will have been developed;

(6) selected private sector construction firms will have the capacity for constructing medium-sized water systems;

(7) about 20 market town water systems and related activities (sanitation, health education and inspection, and quality) will be functioning;

(8) reported cases of malaria will be reduced to an incidence of one per thousand; and

(9) there will be increasing access of the people to population services through the primary health care systems.

(2) Low-Cost Housing Guarantees

Adequate housing has been shown to have important impacts on health and well-being. The GSL has had the provision of low cost housing as a priority goal. However, the high cost and high subsidies involved with its housing program have caused the GSL with AID's encouragement to shift its policy towards increasing private sector participation. To accomplish this the GSL is moving forward, assisted by AID, with the creation of a Housing Finance Bank. This shift will result in:

(1) the movement of the private sector to center stage; and

(2) the GSL's movement towards an exit in the construction of housing.

AID's Housing Guarantee Program (from non-appropriated funds) and modest grant funds will provide capital for the Housing Finance Bank for low-cost housing, and support the policy changes already in evidence and the strengthening of Sri Lanka's housing institutions.

By 1988 we expect that:

(1) the National Housing Bank will be functioning on a self-sustaining basis;

(2) the GSL policy of devoting its housing resources to the very poorest will be in full implementation; and

(3) the Aided Self-Help program will be on a self-sustaining basis.

(3) Education and Training

Our assistance for human resources development is concentrated largely on institution building, technical or managerial training, and increasing the income-earning skills of poor rural groups. Since substantial investments are being made in the formal education system by the World Bank and other donors, we have tailored our efforts to meet specific requests for management, vocation and technical training. Such training is provided, first, as an integral part of our regular projects. We will also increase assistance to local training organizations (especially for the training of trainers) and meet other special training needs under

the Development Services and Training (and its planned successor) and the PVO Co-Financing projects. The former project also supports the improvement of training, research, and consulting activities at such key institutions as the Agrarian Research and Training Institute and the Sri Lanka Institute of Development Administration. Our PVO Co-Financing project has helped to strengthen private organizations which provide vocational or agricultural skills to out-of-school youths, and assists women to improve their income generation activities.

Our Agricultural Education Development project is an important effort to improve the quantity and quality of agricultural specialists. Evidence already exists that AID's relatively small amount of assistance ($7.5 million) will have a significant impact on agriculture and rural development through better educated/trained educators, researchers, policy makers and private entrepreneurs. The impressive potential benefits of our efforts at the University of Peradeniya, plus the increasing demand for agriculturalists in both the newly settled areas and the private sector, have caused the GSL to request USAID assistance for Sri Lanka's new undergraduate agriculture schools which may follow the U.S. land grant model. Upgrading staff and facilities at these institutions will greatly improve the quality and number of graduates available to the public and private sectors and those continuing their education at the Post Graduate Institute of Agriculture (PGIA) at Peradeniya.

By 1988 we expect that:

(1) a complete analysis of manpower needs upon which the GSL can develop its agricultural education plans will have been completed and used as the basis for further investments;

(2) at least two agricultural colleges will have been staffed and equipped and be functioning on the U.S. land grant model; and

(3) the curricula of all agricultural training institutions will have been revised to accommodate the special needs of agro-industry.

(4) Private Enterprise Development

The GSL leadership realizes that, if the country's development goals are to be attained, the private sector will have to play a much greater role in all areas of the economy. The private sector will play a critical role in providing increased investment, employment and incomes which can move Sri Lanka to a self-sustaining growth path.

In support of this policy, the USAID has encouraged the increased participation of the Sri Lankan and U.S. private sectors in the implementation of our on-going projects. Under several projects (Mahaweli Basin Development I and II, Market Town Water Supply-Jaffna, Water Management, and Development Services and Training), we have sought well-qualified U.S. contractors and have encouraged them to sub-contrct elements of design, construction and technical assistance to Sri Lankan private firms.

Beginning in FY 1983, the USAID will assist the GSL in a

phased effort to foster greater private investment in the country's development. The first phase will include a comprehensive assessment of the Sri Lankan private sector, the formulation of a sector development plan, assistance to specific institutions and entrepreneurial development programs, funding of pre-feasibility studies for investments that can yield more immediate impacts (e.g., agro-industry), and promotion of local and foreign investment. The second phase of the USAID's efforts will focus on refining the sector strategy and plan, expanding institutional, managerial, and entrepreneurial development efforts, conducting pre-feasibility studies for other key areas in the sector development plan; and assisting selected investments, technology transfers or joint ventures that fall within AID's legislative mandate and areas of concentration.

By 1988 we expect that:

(1) the institutional capability for managerial training at all levels (senior managers to small entrepreneurs) will be established;

(2) there will be increasing activity of both foreign and local private sectors in agro-processing (both within and outside the Mahaweli area);

(3) there will be an increasing share by the private sector in overall investment with a concommitant drop in the public sector's share.

C. Assistance Levels and Staff

The total assistance levels proposed are composed of

development assistance, PL 480 food aid and housing guarantees. Development assistance represents about half of the total program. Details of the proposed development assistance program are contained in Section III.B.

The PL 480 program is considered an integral part of our program strategy for it will provide quick-disbursing aid which will assist the GSL to meet its food and nutrition needs, a continuing balance of payments problem and budgetary deficits. It will also support AID development programs in agriculture and health. The PL 480, Title I levels represent a continuation of PL 480 wheat imports at a level of about 150,000 metric tons of wheat grain through FY 1988. The Title II levels reflect a phase out of support to the school feeding program and a straight-lining of support for the maternal/child health program, pending the further review of a possible gradual phase-out beginning in FY 1985.

The USAID proposes to continue the Housing Guarantee Program throughout the CDSS period. The program will be directed to support the Housing Finance Bank and low-cost housing; institution building; and policy changes, including the principle of cost recovery and encouragement of the private sector.

U.S. trade and investment resources are increasing and will play an increasing role in Sri Lanka's development. For the first nine months of 1982, the U.S. remained Sri Lanka's first export market and moved up to the fourth largest source of imports. Sri Lanka's trade with the U.S. continues to increase substantially and is projected to reach a level of $155 million in

exports and over $153 million in imports in 1982. Encouraged by the GSL's economic reforms and tax and incentive packages, U.S. foreign investment increased from $500,000 in 1978 to about $8 million by mid-1982. Planned investments by U.S. firms in the Foreign Investment Promotion Zone and fertilizer production will move the U.S. from a minor to a major source of foreign investment in Sri Lanka. Increasing efforts by Sri Lanka to attract potential investors here and to send investment missions abroad, including to the United States, to meet and promote investments are expected to result in further U.S. and other foreign investments.

The level of U.S. assistance proposed reflects, in our judgement, that warranted on the basis of our overall interests in Sri Lanka and our understanding of probable constraints on the U.S. development assistance and food aid programs.

Relative to program size and complexity, the USAID/Sri Lanka is understaffed. However, we believe the program presented in this CDSS can be implemented with only marginal changes over the CDSS period in the size of the U.S. and Sri Lankan direct hire staff, and with some changes in composition to reflect staffing needs due to the modifications in our strategy and proposed program. The USAID will employ the bulk of any additional Sri Lankan professional and support staff on a contractual, rather than direct hire basis.

PROPOSED ASSISTANCE PROGRAM
FY 1984 - 1988 - $ Millions

CATEGORIES	1984	1985	1986	1987	1988	TOTAL
1. Mahaweli Basin Development						
System B - Left Bank	18.5	15.9	-	-	-	34.4
Mahaweli Sector Support	-	7.1	-	-	-	7.1
Mahaweli Environmental Protection	3.5	-	-	-	-	3.5
Mahaweli Downstream Development	-	-	20.0	10.0	20.0	50.0
Sub-Total	22.0	23.0	20.0	10.0	20.0	95.0
2. Food Production and Natural Resource Management						
Irrigation and Water Management	3.5	5.0	10.0	5.0	6.0	29.5
Diversified Agricultural Research, Production and Marketing	3.5	5.0	-	5.0	10.0	23.5
Agricultural Policy and Planning	-	2.0	5.0	-	-	7.0
Alternative Energy Resources and Environmental Enhancement	-	8.0	-	15.0	10.0	33.0
PL 480, Title I (non-add)	(25.0)	(25.0)	(25.0)	(25.0)	(25.0)	(125.0)
Sub-Total	7.0	20.0	15.0	25.0	26.0	93.0
3. Human Productivity and Well-Being						
Health, Population and Nutrition	10.0	7.5	-	15.0	7.0	39.5
Housing Guarantees (non-add)	(25.0)	(25.0)	(25.0)	(25.0)	(25.0)	(125.0)
PL 480, Title II (non-add)	(4.9)	(3.9)	(3.3)	(2.7)	(2.1)	(16.9)
Private and Voluntary Organizations	.5	.5	.5	1.0	1.0	3.5
Development Services and Training (and successor)	.8	1.0	2.0	-	1.0	4.8
Agricultural Education	-	-	10.0	-	10.0	20.0
Private Enterprise Development	-	-	10.0	10.0	-	20.0
Sub-Total	11.3	9.0	22.5	26.0	19.0	87.8
Development Assistance	40.3	52.0	57.5	61.0	65.0	275.8
Housing Guarantees	25.0	25.0	25.0	25.0	25.0	125.0
PL 480, Title I	25.0	25.0	25.0	25.0	25.0	125.0
PL 480, Title II	4.9	3.9	3.3	2.7	2.1	16.9
Total U.S. Assistance	95.2	105.9	110.8	113.7	117.1	542.7

ANNEX A

MACRO-ECONOMIC REVIEW

1. General

The economic review presented in this annex is based on the performance of the economy during the first nine months of 1982. Preliminary data covering the whole year as well as the budget for 1983 have been delayed due to the October presidential eletions and the December referendum. According to official sources, the 1983 budget is now under preparation and it will be presented in Parliament on March 8, 1983.

The current evidence suggests that the economic performance in 1982 will be below expectations. It is anticipated that the growth rate in real gross domestic product (GDP) will be around 5% compared to the 5.8% achieved in 1981. Lower agricultural output was the principal factor contributing to slow growth. The performance of the agricultural sector, which accounts for approximately 25% of the GDP, was adversely affected by the serious drought during the first quarter of 1982 followed by floods during the final quarter. Paddy production was the most severely affected. While the annual target of paddy production set by the Ministry of Agricultural Development and Research for 1982 was 2.6 million metric tons, the 1982 annual production estimate has now been revised downward by 19% to 2.1 million metric tons. At this level, paddy production will be 9% below the 1981 level.

The drought has also caused adverse effects on plantation output, particularly tea production. A 13% drop in tea output has been reported during the first nine months of the year compared with the same period in 1981. Despite favorable weather conditions during the second half of the year, annual tea production is likely to remain about 5% less than the 1981 production of 210 million kilograms. The drought effect on coconut production has so far not been felt, but it will be reflected in the 1983 output since it will take a year or more before the impact of the drought is reflected in coconut production. The 15% increase in coconut production during the first nine months of 1982 will be likely to drop to an annual increase of only 10% due to anticipated production losses during the final quarter of 1982. Rubber production recovered slightly following the poor production performance in 1981 which was due to a decline in prices as well as world demand for natural rubber. 1982 production is expected to show only a marginal increase over 1981, due to reduced tapping days following excessive rains in rubber producing districts.

The manufacturing sector comprises plantation processing industries, factory industries and small industries, and contributes about 14% to GDP. The performance of this sector has been negatively effected largely due to production losses in the tea crop. However, the production performance of factories and small industries appears to have progressed satisfactorily, despite power shortages during the February to April period. While the production performance in the private sector industries is reported

to be good according to unofficial sources, the trend in the expansion of private sector industries since the adoption of the open economic policy has not been sustained. Observers attributed this slow progress in 1982 primarily to the expectation of a presidential election and the uncertainties surrounding the role of the private sector in the event of a change in government. The overall growth rate in the manufacturing sector is tentatively estimated at between 4.5% and 5% compared with the growth rate of 5.2% in 1981. With the re-election of the President and the continuation of his parliamentary majority, the stage is set for continued private sector growth.

The growth rate in wholesale and retail trade which accounts for about 19% of GDP is projected to be around 4.6% in 1982 compared with a 4.2% growth rate achieved in 1981. A higher volume of exports and a marginal increase in domestic trade have contributed to this performance despite a drop in the volume of imports. Although lower 1982 capital budget allocations to the Ministry of Local Government, Housing and Construction constrained the expansion of public sector construction activities, the expansion of public sector construction activities progressed adequately and, as a result, a 4% growth rate is projected in 1982 compared with a 3% decline in 1981. The growth rates of all the other sectors vary between 3% and 6% but their individual contributions to GDP are below 5%, with the exception of the service sector. A growth rate of 6% is projected in the service sector compared to 8% growth rate in 1981.

A substantial reduction in the inflation rate is expected in 1982. The rate of inflation, measured in terms of the Colombo Consumer Price Index (CPI) registerd an 11% increase between 1981 and 1982 compared to increases of 18% and 26% between 1980/81 and 1979/80 respectively. Food items, which account for 62% of the CPI, registered an increase of 12.7% between 1981 and 1982 compared to 18.6% in 1980/81 and 29.0% in 1979/80. The government's timely action in importing rice reduced the impact of production losses of paddy on retail prices of rice. The prices of other basic food commodities such as flour and sugar dropped in the domestic market following a decline in world market prices. The downward trend in the Colombo CPI is supported by a significant drop in the unpublished CPI maintained by the Central Bank. The unpublished index reported inflation rates of 24% between 1980/81 and 38% between 1979/80. They expect a 1981/82 rate of as low as 6%.

Lower public expenditures, compared with the high public expenditure plans announced in the 1982 budget, and the restrictive monetary policies introduced in 1981, which are still in force, also relieved the inflationary pressure. Actual expenditures during the first nine months amounted to 60% of the total budget expenditures, and this reduction primarily came from lower capital expenditures which for the first nine months accounted for only 47% of the proposed capital expenditure plans for 1982.

The change in money supply during the first nine months has also been relatively moderate considering the anticipated large budget deficit in 1982 and the expected high proportion of deficit

financing from banking sources. The growth in money supply (M2) has been around 21% between December 1981 and September 1982 compared to the 18% increase during the corresponding period in 1980/81. Similar to the experience in the past several years, domestic credit expansion has been the major contributory factor for the growth in money supply in 1982. During the first nine months, domestic credit increased by 22% and the annual rate of increase is estimated to have remained around 30% compared to the 33% increase in 1981. The projected increase in 1982 is substantially lower than the 81% increase experienced in 1980. Another important feature in monetary developments during the year was the drop in demand deposits between June and September 1982, along with the announcement of lower interest rates on demand deposits by most commercial banks as a countermeasure to correct the excess liquidity problem. The reduction in demand deposits has been reflected in the increase of cash held by the public and an increase in investments in the share market. Increasing demand for domestic credit since September 1982, mainly by public institutions, required the commercial banks to return the interest rates to previous levels and, as a result, there has been a corresponding increase in demand deposits held by the public in commercial banks.

Notwithstanding the substantial $300 million investment in phosphates by a U.S. company in December, the inflow of private foreign investments during the first nine months of the year was slow. During the first nine months, only 14 projects were approved

and 10 projects signed under the Greater Colombo Economic Commission (GCEC). The foreign investment component of the agreements amounted to $19 million. The number of projects approved by the GCEC now stands at 169 and, of this, 87 agreements have been signed amounting to $115 million of foreign investment. 49 projects are now in commercial production in the GCEC and the total value of exports from the GCEC is expected to increase to around $90 million in 1982 from $62 million in 1981. The number of projects approved within the jurisdiction of the Foreign Investment Advisory Committee (FIAC) total 544, including 85 approvals during the first nine months in 1982. These projects total $500 million in foreign investments. About 150 projects are now in commercial production, according to a recent survey carried out by the FIAC.

The employment generating capacity of the economy appears to have been constrained during 1982 due to limited potential for new employment in ongoing development projects and the lower priority of the government for new development projects due mainly to the limitations on financial resources. Employment generating capacity in the private sector, which usually accounts for a greater proportion of new employment, has also been somewhat limited because of the slow expansion of business and economic activities during 1982. Although an official unemployment rate has not been announced for 1982, observers believe that the rate of unemployment in Sri Lanka was not lowered during the year due to the reduced growth performance in the economy. The continued upward trend in emigration for employment to the Middle East, however, provided

some relief to the unemoloyment pressures. The GSL's tentative unemployment rate for 1982 will be near the 1981 figure of 15%.

2. Balance of Payments

The balance of payments situation is expected to remain about the same in 1982. Based on trade figures for the first seven months, the annual trade deficit will be around $800 million. While the total value of exports is expected to increase by about 10% the value of imports will experience a slower growth of around 6% The annual expenditure on food imports is expected to decline by about 15% in 1982 compared to 1981 in current prices, partly due to reduced demand and lower world market prices. Despite an expansionary budget, only a marginal increase is anticipated in the expenditure on investment goods, due, at least partly to: (1) A substantial under expenditure in the capital budget; (2) leveling off of pent up demand for imports in certain categories; and (3) restrictions on commercial credit for import financing. However, expenditures on intermediate goods, with oil imports accounting for a major share, are expected to increase by about 20%. Expenditure on oil imports rose by a staggering 40% during the first seven months compared to the corresponding period in 1981 as a result of increasing demands for thermal power generation and transportation. According to official sources, the volume as well as the weighted average price of crude oil have gone up during the year by 10% each. The annual crude oil bill will be around $450 to $500 million, representing an estimated 24% of the total value of imports and about 43% of the total value of exports. Increasing

value of industrial exports comprising textiles, garments and petroleum products will account for the expected increase in export value in 1982.

The balance of payments situation appears to have not undergone extraordinary pressures during 1982 as evidenced in the more stable position of the Sri Lankan rupee against major currencies, with the exception of the U.S. dollar. Increasing remittances from Sri Lankans working in the Middle East, moderate growth in tourism earnings, and the satisfactory disbursements of foreign assistance are helping to keep the balance of payments within reasonably managable levels. Receipts from Sri Lankans working abroad are expected to reach an all time record of $300 million, making this source the second largest foreign exchange earner after tea. Gross disbursement of foreign assistance will also show a reasonable increase of about 20% as the total disbursements are expected to be around $500 million. A 10% increase in the total tourist arrivals has been projected for 1982 and this increase, along with the increase in per capita tourist expenditures, will enhance earnings from tourism by at least 15% over 1981 to reach an annual total gross income of $125 million. These major sources of financing the balance of payments will still leave a net unfinanced gap of around $200 million after making adjustments for: (1) amortization of foreign loans; (2) repayment of short-term commercial credits; and (3) re-purchase of the rupee from the IMF under the Extended Fund Facility (EFF) and Compensatory Fund Facility (CFF) schemes available to Sri Lanka as

balance of payments support during the 1979-81 period. Amortization of foreign loans is expected to increase by about 25% during 1982 and this will be reflected in a higher projected debt service ratio of 14.5% compared to 13.4% in 1981.

While potential sources of financing for the resource gap are new EFF and CFF agreements with the IMF, commercial credits and external reserves, the GSL is likely to utilize its reserves only if funds from other sources are not forthcoming. Although there were no EFF or CFF agreements during 1982, the possibility still exists for new agreements to cover the 1982 external resource gap. The gross external reserves at the end of September 1982 stood at $487 million showing a marginal increase of 9% compared to the year end reserve in 1981. The reserve position is adequate for three months' imports.

ESTIMATED AID DISBURSEMENTS - 1982
(January to September - $ Million)

DONORS	PROJECT ASSISTANCE Loans*	PROJECT ASSISTANCE Grants**	COMMODITY ASSISTANCE Loans*	COMMODITY ASSISTANCE Grants**	TOTAL
1. Multilateral					
ADB	12.41	-			12.41
IBRD/IDA	46.51	-			46.51
IFAD	1.22	-			1.22
EEC		1.66		6.96 a/	8.62
U.N.Group		7.31			7.31
WFP		2.82			2.82
Sub-Total	60.14	11.79		6.96	78.89
2. DAC					
Australia		.89		7.43 b/	8.32
Canada	12.73			2.93	15.66
Denmark	.09		.21		0.30
France	9.54		.25		9.79
Germany (FRG)	.80				0.80
India			2.29		2.29
Japan	4.47		23.20	4.50	32.17
Netherlands			7.70	6.45	14.15
Norway				2.19	2.19
Sweden	2.06	2.55			4.61
U.K.		40.34			40.34
U.S.A.	44.46 c/	2.40	9.11 d/	3.94 e/	59.91
Finland				.07	.07
Sub-Total	74.15	46.18	42.76	27.51	190.60
3. Communist					
China	5.06				5.06
U.S.S.R.	.04				.04
Sub-Total	5.10				5.10
4. Others					
Kuwait	1.22				1.22
OPEC	5.88				5.88
UAE	1.08				1.08
Saudi Arabia	.03				.03
Switzerland		0.72			0.72
Euro-Currency			40.00		40.00
Sub-Total	8.21	0.72	40.00	00.00	48.93
Total	147.6	58.69	82.76	34.47	323.52

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NOTE: a/ Food aid.

b/ Includes $3.26 million food aid.

c/ Includes AID Housing Investment Guarantee loan of $14.55 million.

d/ Includes PL 480, Title I, loan of $9.09 million.

e/ Includes $3.94 million food aid (CARE).

* Loan disbursements are for the priod January to September 1982

** Grant disbursements are for the priod January to June 1982

Source: Department of External Resources, Ministry of Finance and Planning

ANNEX C

THE PRIVATE SECTOR

The USAID is planning a FY 1983 private sector project which will include a detailed sector assessment. This assessment will provide a thorough description of the private sector and an analysis of the policy environment and constraints to further private sector expansion. This analysis will also provide a base for the AID's future private enterprise undertakings. The purpose of this presentation is therefore limited to describing the Sri Lankan private sector as we currently know it. A more elaborate analysis will be forthcoming from the sector assessment.

1. The Role of the Private Sector in Sri Lanka

While there have been no definitive studies on what exactly constitutes the "private sector" in Sri Lanka, the following rough breakdown of the private/public mix in the economy outlines the private sector.

Employment: The Sri Lankan labor force was estimated at about 5.6 million in 1980 with an unemployment rate of 15%. Of the total employed workforce of 4.76 million, an estimated 2.8 million or 58% are in the private sector. Private sector employment is heavily concentrated in agriculture and trade.

Agriculture: In Sri Lanka the crops subsector dominates agricultural production and the cultivation activity is mostly

confined to private farms that operate within the market framework. The agricultural sector provides employment to about 45% of the labor force.

Paddy land is owned almost exclusively by private smallholders and is the main source of employment for nearly 800,000 people. 90% of the rice milling capacity is in private hands and rice is sold in a free market setting with the Paddy Marketing Board making purchases under a Guaranteed Price Scheme designed to provide a minimum selling price to paddy producers. Prior to 1977, the government had a near monopoly on rice marketing.

Coconut is essentially a smallholder crop with only 10% of the land under state ownership. The coconut sector provides employment for 100,000 persons in cultivation and about 30,000 in the processing industry.

The rubber sector provides employment for about 200,000 people. Approximately one-third of the rubber land is under state ownership with the remaining two-thirds cultivated by private smallholders.

The government owns nearly two-thirds of the total tea acreage with the balance being held by smallholders. The cultivation of tea employs an estimated 700,000 persons.

Industry: Manufacturing industries consist of: 29 public sector corporations; about 9,000 registered private factories composed largely of small and medium industry firms with fixed assets of under $50,000; and over 20,000 unregistered small and

cottage industries. The public sector industrial corporations, including the petroleum refinery, account for over 50% of industrial output. Output value in private factory industries grew by an average of 7.2% in the 1977-80 period while small cottage industries grew by 9.4%. Small and medium industries account for over 90% of private industrial units, over 70% of employment and over 55% of value added in private manufacturing.

About 65% of the registered small and medium industries are in and around Colombo, with secondary concentrations in the Kalutara, Kandy, Matara, Jaffna, Galle and Kurunegalle districts. Unregistered small and cottage industries are more widely dispersed among small towns and villages with the Colombo district representing only about 30% of the units.

The main small and medium industry product groups, constituting about 90% of the employment and 85% of the investment in registered small and medium industries are textiles and garments; light engineering; rubber and chemical goods; wood and paper products. Product concentrations among unregistered small industries are found in related lines, handlooms, pottery, jaggery, blacksmithing, sheet rubber, rice mills and bricks.

The role of public enterprises is decreasing and the GSL is looking to the private sector to lead the way in industrial expansion. The public sector will not be allowed to expand in to new areas of industrial activity, but is being restricted to improving existing operations. Except for the production of essential items, all state-owned enterprises are being held to a

standard of financial viability and are required to compete on an equal and non-discriminatory basis with the private sector and among themselves.

Wholesale and Retail Trade: Wholesale and retail trade are time honored traditions in Sri Lanka and have long provided a major outlet for private ambition. Import/export trade is confined largely to the Colombo area, while trade aimed at the domestic market is scattered around the country, centered mainly in the regional urban centers of Colombo, Kandy, Jaffna, Trincomalee, Batticaloa, and Galle. Public sector involvement is concentrated in the regional wholesale cooperatives and the retail multi-purpose cooperative societies.

Construction: The construction sector is dominated by the government through such agencies as the Urban Development Authority, the Building Materials Corporation and the State Construction Company.

Commercial Banking Sector: The Sri Lanka banking system is composed of two state banks, the Bank of Ceylon and the People's Bank, two indigenous commercial banks and nineteen foreign banks, four of which are American. The banking sector has been experiencing a boom the last couple of years and despite increased competition from the new foreign banks, the local commercial banking sector has reported unprecedented profits. The two state-owned banks control the major share of the country's banking deposits.

Investment: Gross domestic investment in 1981 totalled about $1.2 billion or 29% of GDP up from $575 million in 1977. The government estimates that private investment in 1981 totalled about $512 million as opposed to $730 million by the public sector. The present high levels of public investment are attributable to heavy public undertakings on essential infrastucture development during the 1977-85 period in order to support private sector activity during the mid-1980s. By 1986 it is expected that public and private investment levels will be equal and will account for 26% of GDP. A stock exchange was established in September 1982 which should help facilitate investment in the private sector.

Composition of GDP: Looking at the private sector from a macroeconomic perspective, the following is a very rough breakdown of Sri Lanka's GDP between the public and private sectors, based on the sectoral discussion above.

COMPOSITION OF GDP, 1981

(Percent)

	Total	Public	Private
Agriculture	28	6	22
Manufacturing	18	10	8
Construction	8	6	2
Wholesale/Retail Trade	17	3	14
Other Services	27	19	8
Other	2	1	1

2. Current GSL Policy for the Private Sector

The GSL's Public Investment Program for 1981-1985 states: "The essence of the liberalized economic policies introduced in 1977 was to create the climate necessary to stimulate private enterprise and provide a larger role for the private sector. A vital private sector is necessary to meet the goals of increasing employment, efficiency and output. While public sector investment depends greatly upon the resources which can be generated by the private sector, public investment in essential infrastructure and expansion of the production base is seen as complementary and not competitive to the efforts of the private sector, nor as a substitute for private sector investment. This realization is fundamental to the government's decision to reduce planned public investment so as not to pre-empt the private sector and to provide a strucutre of incentives to that sector."

The GSL's industrial policy is "to foster the optimum utilization of existing capacity and the judicious creation of additional or new capacity, particularly in industries which have high export and employment potential and are complementary to the development of other priority sectors like agriculture."

In order to promote private investment in specific areas, the government established a number of new institutions and agencies. These are the Greater Colombo Economic Commission, the Export Development Board, the Foreign Investment Advisory Committee and the Local Investment Advisory Committees. In addition, the GSL also set up the National Development Bank to look at the specific

needs of medium and long-term investment credit in the country.

The government's policy changes have resulted in accelerated growth in industrial output, employment and exports as is evident from the following figures:

SELECTED PERFORMANCE INDICATORS FOR THE INDUSTRIAL SECTOR
1977 - 1981

	1977	1978	1979	1980	1981
Value Added (Rs. Million)	2,688	3,109	3,437	4,726	6,000
Capacity Utilization (%)	60	70	72	73	74
Advances by Financial Institutions (Rs. Million)	1,273	2,191	2,709	3,256	3,453
Employment (Number)	118,576	136,168	146,260	154,563	162,000
Exports Value (Rs. Million)	941	1,944	3,737	5,485	7,059
Percentage Share in Total Exports	-	15	24	32	34

Although progress in the industrial sector has been impressive, the sector is still in its infancy and its real potential has not been achieved due to a number of constraints. Some of these are inadequate entrepreneurship and managerial expertise, lack of technical knowhow, lack of easy availability of capital and long-term financing facilities, and weak infrastructural facilities in certain areas which have not kept pace with the fast growing requirements of the sector and possible constraints dealing with tax and tariff concessions. Further, the growth of industrial output has shown fluctuations which could be attributed to the heavy dependence of the volume of output to a few industrial groups only. To enable the sector to achieve the envisaged rate of growth, corrective measures would have to be taken including the identification of industry-specific bottlenecks, rationalization of facilities and support services, and further strengthening of investment and promotional incentives and policies.

3. The Private Sector Development Process in Sri Lanka

In developing countries which have experienced relatively long periods of socialist regulation of the economy and limited private access to the foreign exchange markets, there is an almost inevitable sequence* of events which marks the early years of the liberalization. It is important to understand how universal these are as one seeks to assess the performance of Sri Lanka's private sector. Most of the early period after a liberalization involves

*The description of the liberalization sequence is attributed to John Stuart Blackton.

the satisfation of pent-up consumer demand and the redirection of a scarcity-oriented trading and commercial sector to the operation of a free market. The conventional features of the early years after liberalization involve a sequence of events as outlined below:

- imported goods flood the markets and consumers are euphoric while traders grow rich overnight.

- the new money from trade goes in to real estate and land prices and rents rise dramatically, squeezing some while enriching others.

- the banking system expands dramatically, attracting new deposits (usually in foreign exchange at near-euromarket rates). Depositors are initially euphoric because of the high nominal interest rates.

- the Consumer Price Index rises at historically unprecedented rates and euphoria begins to wither among the less favored groups.

- trade and commerce continue to predominate in the private sector and the government begins to worry about the problems of directing resources to productive investments rather than trade.

- the banking and trading constituencies (who are making a killing in commercial transactions) resist pressures to diversify their investment portfolios towards production, and public criticism of financial intermediaries mounts.

- government begins to re-examine the social and political costs of liberalization and to consider alterations in

policy to respond to the new distortions.

To date, Sri Lanka has kept rather closely to the liberalization libretto. The first years after 1977 witnessed massive imports of consumer goods as traders, conditioned by years of scarcity, overinvested in inventory and saturated the markets. Consumers, likewise accustomed to scarcity or at best to uncertainty in the marketplace, displayed the "hoarding response" which usually follows years of artificially restrained consumer demand. At the same time, free foreign exchange and new sources of commercial wealth combined with greater access to the banking system to fuel a housing and construction boom in 1978 and 1979. Speculation in real estate was rampant and contractors and land speculators were among the earliest beneficiaries of the new policies. Inevitably there were some sharp market corrections after the initial frenzy and the traders found themselves faced with unanticipated carrying costs on speculative inventory while the land market slackened somewhat in 1980. The liberalization has, however, undeniably reshaped the domestic economy of Sri Lanka and evidence of the changes is abundant.

Sri Lanka was at this point of critical re-examination of the liberalization during 1982. The process was hastened by the presidential elections and referendum of late 1982. This was a critical threshold in an economic liberalization program, and nations which cross that threshold successfully begin to reap the genuine developmental returns to the policies, while those that retrench too fast provide grist for the critics who argue that free

market policies benefit only traders and speculators. Some Sri Lankans in 1982 were openly critical of many of the results of the 1977 liberalization. They sensed a serious quantum of wastefulness in the consumption patterns that have accompanied the new policies and noted with concern the limited new private productive investment in the country.

Some were drawn to the facile conclusion that a retrenchment was in order, but this viewpoint misses much important groundwork that has been laid for an expanded productive role for private investment and private entrepreneurship. The return of the current government to office was an endorsement of the liberalization policies of the past five years and it is expected that future policies will encourage an expanded role for the private sector.