

PAPERS FOR THE SRI LANKA AID GROUP MEETING

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AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

MAY 22 1985

MEMORANDUM

TO : See Distribution Below

FROM : ANE/ASIA/PNS, John N. Gunning

SUBJECT: Staff-Level Inter-Agency Meeting for the
Sri Lanka Aid Group Meeting in Paris

TIME: May 28, 1985, 1:30 p.m., Room 6210, New State

This binder contains background and issues papers related to the 1985 Aid Group meeting. We will conduct a staff level review of these materials from 1:30 to 3:00 P.M. Tuesday, May 28, 1985 in Room 6210 New State. Our task will consist of reviewing the issues papers and reaching agreement on the basic positions which the U.S. Delegation should take at the Sri Lanka Aid Group meeting in Paris, June 20, 1985. (The final Inter-Agency meeting on this subject will take place at 2:00 P.M. on June 10, 1985 in Room 5951 New State. A.I.D. Counselor James Norris will chair that meeting.)

The members of the Sri Lanka Aid Group generally come together once a year in a meeting convened by the World Bank. You will find summaries of the 1984 Aid Group meeting behind Tab N.

The upcoming meeting will follow the normal pattern: a general review of Sri Lanka's overall economic condition and prospects followed by pledges for the coming year.

Attachments

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SRI LANKA AID GROUP MEETING
JUNE 20, 1985
PARIS, FRANCE

B

ISSUE # 1
ECONOMIC PERFORMANCE

STATEMENT: What should the U.S. Delegation say about Sri Lankan economic performance over the past year?

DISCUSSION. The Sri Lanka economy did fairly well in 1984. The World Bank's annual report (summary at Tab G) and a USAID "Macro-Economy Review" (Annex to "Policy Dialogue Framework" at TAB I) describe the country's economic performance and problems. A new IMF report (April 25) indicates that Sri Lankan economic performance in 1984 was, "on the whole, fairly favorable, because of a nearly 20% improvement in the external terms of trade (owing mainly to high tea prices), the recovery of tea production, ...and a sharp increase in garment exports. Real GDP grew by 5%." The IMF also noted that the government budget deficit was reduced significantly from 13.4% of GDP in 1983 to 10.2% in 1984.

USAID, the Bank and the Fund also stress problems, above all the unrealistic exchange rate which continues to encourage imports and hurt exports. Other economic problems include a savings rate that is inelastic and unsatisfactory, and the performance of unprofitable public sector corporations that continue to drain GSL resources.

We concur that Sri Lankan economic performance last year was favorable, especially in view of the escalating insurgency. However, we and USAID feel such favorable performance may be unsustainable in the absence of policy reforms. High tea prices (already dropping) were a welcome windfall last year that masked major imbalances. The drop in the GSL budget deficit in 1984, while welcome, was less than the GSL's initial target; the deficit could be greater than 10.2% once all supplemental appropriations expenditures are recorded, especially those for national security. Also, the impetus for privatizing the economy seems to have slowed considerably. Much work is needed if Sri Lanka is to achieve economic growth on a sustainable basis.

RECOMMENDED U.S. POSITION. The U.S. should stress the need for exchange rate adjustment, increased savings, expenditure control, and improving the environment for private investment.

ISSUE # 2
INDUSTRIAL SECTOR GROWTH FOR EXPORT

STATEMENT: Is the GSL doing enough to improve the policy environment that will increase private investments in the industrial sector and lead to higher rates of sectoral growth in exports? What has the GSL done to follow-up with its policy intentions to improve the efficiency of the public enterprises?

DISCUSSION: Since 1977 and the beginning of economic policy liberalization, the industrial sector has consistently ranked the lowest of all the major economic sectors in overall growth rates. 1977 policy changes benefitted the industrial sector by providing investment incentives through the dismantling of extensive price control and foreign exchange control systems, tax holidays for industries that were 100% export-oriented, and an export promotion program that, while useful, has been restricted in its impact by both mandate and budget. However, as indicated by the low growth rates, these measures have had very limited success in what has been an import-substitution dominated policy environment. Significant growth in the sector is dependent upon greater export diversification, and this is dependent primarily upon three factors, a currency evaluation that will make Sri Lankan manufactured products competitive in the world markets, a tariff system that effectively rids itself of its import-substitution bias and encourages domestic production for export, and improved effectiveness in the public enterprises. The nominal rate of the rupee has been devalued several times since 1977 vis a vis the U.S. dollar, but with an almost simultaneous increase in the appreciation of the real rate with regard to the currencies of Sri Lanka's major trading partners. There has been some progress towards a more appropriate rate but not enough to assure the flexible exchange rate policy that is needed to make exports responsive to fluctuating world market prices.

With regard to tariff restructuring, the GSL has introduced various changes since 1977. The earliest of these increased the levels of protection for the manufacturers of certain selected products with public enterprises usually the principal beneficiaries of such adjustments. Subsequent tariff changes were frequently little more than symbolic in impact, did little to reduce the disparities in the protection afforded by these actions amongst manufacturers, and, in addition, retained an essentially import-substitution policy bias. Last November, the GSL announced additional reforms in the tariff structure to reduce disincentives against production for export, while at the same time providing continuing protection for domestic industries. Under these reforms which are part of the GSL's 1985 Budget, import tariff reform, a change in export taxes on tree crops and the establishment of a stabilization fund for tea and rubber were announced. What isn't clear is whether in the implementation of the reforms, their domestic industry protection objective will, as in the past, take precedence over their export

objective. If it is the former, most manufacturing export industries will remain in the low protection group while the highly protected group, including most notably import-substitution producing public enterprises will be the advantaged to the disadvantage of increased exports and Sri Lanka's economic growth. The diversification of growth in industries will need to focus on export markets and much more efficient import substitution. Much remains to be done to make this a reality.

Public enterprises account for about 40% of all manufacturing activity in Sri Lanka. They have been acknowledged by the GSL to be inefficient production units but little has been done to make them more efficient. The 1985 budget has taken improved government and parastatal management as a major theme, and the Finance Minister is urging that the large subsidies for public enterprises end as a major deficit-reducing measure. Whether he will be successful remains to be seen. The enterprises have powerful political support within the urban constituencies where they are located. Some also see them as necessary to keep unemployment in check. While employment in the enterprises did increase 59% between 1976 and 1979 it was at great cost to economic efficiency -- their output grew only 8% during the same period. The Finance Minister has said that no new project will be undertaken by the state if it can be handled better by the private sector. Shortly after this statement was made, the government opened a new retail food outlet selling goods at prices less than private retail traders.

RECOMMENDED U.S. POSITION

1. The Government of Sri Lanka (GSL) should be commended for its new tariff policy reforms and urged to fully implement these in order to significantly strengthen the incentives climate, and provide support services and infrastructure for private investments in the production of those industrial products where Sri Lanka has a comparative export advantage. Specifically, the U.S. should stress the need for the GSL to make this objective primary and overriding in instances of conflict with the other announced objective for undertaking the policy reforms, i.e., protection of domestic industries.
2. With respect to devaluation, the U.S. should emphasize the need to reach agreement with the IMF on a flexible exchange rate in order to expand exports. The GSL may be more inclined to move in this direction now that the world market price for tea, its primary export, has dropped significantly from the high levels of a few months ago.
3. Regarding public enterprises, the USG should press for an agenda of specific GSL actions based on Industrial Policy Committee recommendations, to improve the efficiency of the enterprises.

ISSUE # 3
GOVERNMENT EXPENDITURES

STATEMENT: The Government is working on improving the quality of government expenditures. However, the percentage of GDP devoted to public spending remains high, and leaves limited room for private investment.

DISCUSSION: The GSL managed to reduce its budget deficit from 13.4% of GDP in 1983 to 10.2% in 1984. However, national security expenditures are escalating in light of the insurgency, and other initiatives are imperative such as adequate budgeting for maintenance and operation of expensive capital investments. These need to be accomplished while shrinking public expenditures as a percent of GDP if the GSL's policy of relying on private investment is to work.

The task became harder in the past two months as tea revenue projections declined. The Cabinet and the Ministry of Finance must be firm in resisting new initiatives in order to hold the line.

Concessional donor assistance is key to maintaining a healthy economy in the face of rising insurgency and security costs. However, aided-projects also have an impact on domestic resources. Some USAID-financed projects, particularly with the Ministry of Lands and Land Development, have been hampered by inadequate GSL contributions, and the Mission is approaching new project commitments with caution. The GSL should carefully weigh offers of donor assistance, and fully finance those which they accept.

RECOMMENDED U.S. POSITION.

1. The GSL should make strenuous efforts to reduce the budget deficit through both restraints on expenditures and a better revenue effort. While the Government has eliminated many subsidies over the past few years, those remaining are logical candidates for elimination. The Government can little afford to subsidize inefficient parastatal corporations through transfers and advance account payments which will not be repaid.
2. The GSL should carefully limit projects undertaken to those that can be adequately budgeted within the resources available.
3. Tax reforms, as discussed with the IMF, are needed to promote greater elasticity. The GSL also should move further with cost recovery programs, including the social sectors. Users fees for irrigation water have been announced. Greater enforcement of these is needed, as well as collection of other utility fees and loan repayments. Fees for curative health services also should be considered. User fees will help generate additional funds for operations and maintenance, and act to reduce inefficiencies by reducing excess demand.

ISSUE # 4
MANAGEMENT IMPROVEMENT

STATEMENT. GSL Government organization and procedures are overly complex and hinder its development programs.

DISCUSSION. Despite the need for reduced expenditures and better management of resources, the Government's own structure continues to grow. There are now 45 ministries and over 160 agencies, most of which have overlapping responsibilities and poor coordination. The World Bank and USAID both are discussing management improvement activities with the GSL to address this problem. There is an urgent need for the Government to rationalize its governmental organization, joining appropriate functions and eliminating unnecessary ones. The World Bank hopes to address such across-the-board problems as inadequate professional salary scales, and overall GSL organization. USAID plans to work at the sectoral level in connection with its project program.

One example of the problem is that of agricultural research in which five ministries have separate programs. This makes farm systems research very difficult. USAID recently helped the GSL to prepare a draft agriculture/food/nutrition strategy, and found that the lead agency had to be the Ministry of Finance and Planning because of the fragmentation of policy development among the line ministries. The Mission is pressing for an agricultural research council as an interim step, but believes organizational simplification would be much better.

RECOMMENDED U.S. POSITION. The Delegation should refer to the need for rationalization of the Government's structure, making specific mention of the coordination of agriculture research. This is an area in which USAID and other donors are heavily involved.

ISSUE # 5
POPULATION GROWTH

STATEMENT. During the past decade, the Sri Lanka rate of natural increase of population has been at a relatively stable, high, 2.1% plateau in one of the most densely population areas of the world. During this time the population growth rate of the country has dipped to a low of 1.4% due to a high level of out-migration. This reduced rate of population growth cannot be sustained as out-migration declines.

DISCUSSION. The 2.1% rate of natural increase is comparable to that of India and Indonesia and greater than that of Thailand. If this rate continued unabated, the population would double to 33 million in 33 years (2018). With the exception of the June 1983 increase in cost reimbursement to sterilization acceptors by the Government of Sri Lanka (GSL), no major new initiatives have been undertaken to address this problem of high rate of natural increase.

A USAID health/population sector review in 1983 and a World Bank PHN sector assessment in 1984 both strongly recommended increased GSL efforts to reduce the rate of population growth. The USAID review suggested that additional investments in population to improve family planning services emphasize non-permanent or birth spacing methods of contraception. The review also identified a number of institutional problems and other constraints impeding efforts to improve family planning program performance. The feasibility of improving program efforts could be enhanced if the MOH, which delivers 85-90% of family planning services, placed more budgetary emphasis on preventative services and worked to increase the degree of community participation. Greater coordination of population activities between the MOH, the Population Division of the Ministry of Plan Implementation, and the non-governmental organizations (NGO's), plus a willingness by the Ministry of Finance and Planning to provide additional resources for family planning would enhance the likelihood of program impact.

RECOMMENDED U.S. POSITION.

1. The Delegation should urge an increased budget for the Ministry of Health (MOH) to support the promotion and delivery of non-permanent methods of family planning.
2. The MOH should coordinate with the Ministry of Plan Implementation, Population Division, in seeking increased resources and in setting objectives for increasing the emphasis on non-permanent methods of contraception.
3. The GSL should encourage greater community participation in family planning, perhaps by utilizing volunteers to deliver family planning information and services.

ISSUE # 6
COMMUNAL CONFLICT

STATEMENT: The insurgency in Sri Lanka is worsening, with alienation of the minority Tamil population rapidly increasing. Can the Government's development program continue as before in view of this new competition for scarce financial resources? To what extent does the insurgency directly impinge on development programs?

DISCUSSION. The security situation, its effect on the economy and on development programs are of major concern. The terrorist and counter-terrorist campaigns have affected some development projects already. A.I.D. had to terminate assistance to the Market Town Water Supply Project in the Jaffna District because the Government could not provide assurances that security in the District would be adequate. Other projects near the Northern and Eastern Provinces are beginning to be impacted as well.

For the most part, the serious economic disruption has been confined until recently to the northernmost part of the country which contributes only a small share of total GDP. However, the ethnic disturbances in the Eastern Province have now disrupted activities in an area more important economically.

Another aspect of this problem is the growing share of resources devoted to national defense. The original 1985 defense budget of Rs. 3.4 billion already had increased to Rs. 4.9 billion by mid-May, representing approximately ten percent of the estimated total budget for 1985. President Jayewardene then announced further defense increases after the tragic Anuradhapura incident. These additional expenditures will have to be financed either through increasing the deficit or reducing the funds available for development programs. Neither is a very attractive alternative from a donor's perspective.

USAID/Sri Lanka estimates that, due to terrorism, one-fourth to one-third of the domestic market may be lost in the north and east where such problems as curfews and lack of transport, production inputs and markets, severely restrict economic activity. Fisheries production, for example, is down about 40 percent with resulting higher fish prices in the market place. The problems in the east have also brought the unrest close to the geographic zones with concentrations of donor activity, particularly the Mahaweli region.

USAID/Sri Lanka reports that virtually all Colombo representatives of donor countries believe their governments should speak at Paris about the increase of violence since the last meeting, the effects on development, and the need for a political solution. USAID considers it likely that a number of countries will make statements along these lines.

RECOMMENDED U.S. POSITION.

1. The U.S. delegation should state that we view resolution of the communal conflict to be the highest priority facing the Government. The increasing alienation of a large minority group not only makes the insurgency much more difficult to combat, but is souring the reputation of a country which has been viewed as an outstanding example of how democracy, economic growth, and a concern for basic human needs can be combined.

2. The U.S. delegation should ask the GSL for a realistic assessment of what the Government believes can be carried out in the way of development programs, given the current security situation. How much attention is the Government going to have to devote to defense-related issues and at what cost to the development effort? How can donor assistance be used to help bring about or implement a political solution. One example might be the restoration of productive capacity in the troubled areas.

ANA/ASIA/PNS, 5/2/85,1409c

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U.S. GENERAL STATEMENT
FOR THE SRI LANKA AID GROUP
JUNE 20, 1985

MR. CHAIRMAN:

FROM AN ECONOMIC STANDPOINT 1984 WAS A PARTICULARLY FAVORABLE YEAR FOR SRI LANKA, WITH A REAL GROWTH IN GDP OF ABOUT FIVE PERCENT. MUCH OF THIS WAS HELPED BY HIGH TEA PRICES, THE RECOVERY OF TEA PRODUCTION, AND A SHARP INCREASE IN GARMENT EXPORTS. AS A RESULT, COMMERCIAL BORROWING WAS REDUCED, AND OFFICIAL FOREIGN EXCHANGE RESERVES ROSE TO A LEVEL OF 3.5 MONTHS OF IMPORTS. THE GOVERNMENT BUDGET DEFICIT WAS REDUCED TO 10.2 PERCENT OF GDP IN 1984, ALTHOUGH SUPPLEMENTAL BUDGETS DURING THE YEAR PREVENTED THE GOVERNMENT FROM MEETING ITS INITIAL TARGET FOR DEFICIT REDUCTION.

ON THE OTHER HAND, A NUMBER OF TROUBLING ECONOMIC PROBLEMS ALSO BECAME MUCH MORE EVIDENT IN 1985. SRI LANKA'S HIGH EXCHANGE RATE CONTINUES TO ENCOURAGE IMPORTS AND HURT EXPORTS. THE DOMESTIC SAVINGS RATE IS INELASTIC AND UNSATISFACTORY, AND UNPROFITABLE PUBLIC SECTOR CORPORATIONS CONTINUE TO DRAIN GOVERNMENT BUDGET RESOURCES. ESCALATING DEFENSE COSTS ADD ANOTHER BURDEN.

THE SRI LANKAN ECONOMY IS LIKELY TO FACE A DIFFICULT BALANCE OF PAYMENTS POSITION IN 1985 AS TEA PRICES DECLINE FROM THEIR 1984 HIGH. LOWER PRICES FOR TEA WILL ALSO CONTRIBUTE TO A HIGHER BUDGET DEFICIT UNLESS THE GOVERNMENT TAKES QUICK ACTION TO CUT EXPENDITURES.

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'THE UNITED STATES CONCURS WITH THE RECOMMENDATIONS OF THE IMF AND WORLD BANK THAT THE GOVERNMENT SHOULD MAKE EVEN GREATER EFFORTS TO REDUCE THE BUDGET DEFICIT -- THROUGH RESTRAINTS ON EXPENDITURE AND COMPREHENSIVE EFFORTS TO INCREASE REVENUES, ESPECIALLY THROUGH USER FEES AND MORE EFFICIENT COLLECTION OF TAXES AND FEES. IDEALLY, BUDGET DEFICITS SHOULD BE HELD TO BETWEEN 8 TO 10 PERCENT OF GDP AND FINANCED PRIMARILY FROM CONCESSIONARY SOURCES. ON THE MONETARY SIDE, BECAUSE INTEREST RATES REMAIN HIGH DESPITE THE DECLINE IN INFLATION, MOST PRIVATE SECTOR FIRMS CANNOT FINANCE INVESTMENT THROUGH COMMERCIAL BANK BORROWING. WE WOULD RECOMMEND THAT THE GOVERNMENT ADOPT A MODERATELY EXPANSIONARY MONETARY POLICY WHICH PROVIDES SUFFICIENT CREDIT FOR NEEDED INVESTMENT BUT DOES NOT REKINDLE INFLATIONARY PRESSURES. BUT THIS OBJECTIVE CANNOT BE ACCOMPLISHED WITHOUT IMPROVED FISCAL DISCIPLINE. A RESTRICTIVE FISCAL POLICY SCALING DOWN THE PUBLIC INVESTMENT PROGRAM WOULD BE HIGHLY APPROPRIATE. THESE POLICIES SHOULD BE LINKED TO A DEVALUATION OF THE RUPEE TO IMPROVE EXPORT COMPETITIVENESS AND TO REDUCE THE DEMAND FOR IMPORTS.

WE DO HIGHLY COMMEND THE GOVERNMENT'S CONTINUING EMPHASIS AND INTENTION TO RELY ON THE PRIVATE SECTOR FOR ECONOMIC GROWTH. THE TARIFF CODE REVISIONS MADE LAST WINTER SHOULD REMOVE SOME OF THE ANTI-EXPORT BIAS WHICH HAD HINDERED SOME TYPES OF INVESTMENT. WE WOULD RECOMMEND THAT THE GOVERNMENT MOVE QUICKLY TO IMPROVE FURTHER THE CLIMATE FOR ENHANCED INVESTMENT, FOR PRIVATE SECTOR

GROWTH, AND FOR INCREASING THE PRODUCTIVITY OF THE NON-GOVERNMENTAL SECTOR. THE HIGHEST PRIORITY, IN OUR VIEW SHOULD BE GIVEN TO IMPROVING THE MACRO-ECONOMIC ENVIRONMENT. NEXT, THERE IS A NEED TO ARTICULATE AN INDUSTRIAL DEVELOPMENT POLICY WHICH IS CLEAR AND PREDICTABLE, AND UPON WHICH PRIVATE ENTREPRENEURS CAN RELY IN MAKING INVESTMENT DECISIONS. WE WERE PLEASED TO LEARN THAT THE GOVERNMENT HAS FORMED A HIGH LEVEL COMMITTEE WHICH WILL RECOMMEND SUCH A POLICY TO THE CABINET LATER THIS YEAR.

WE HOPE THAT THIS NEW COMMITTEE AND THE COMMITTEE ON PUBLIC ENTERPRISES WILL DEAL FORTHRIGHTLY WITH THE QUESTION OF PUBLIC CORPORATIONS. WE ENCOURAGE THE GOVERNMENT TO DIVEST PUBLIC ENTERPRISES AS EXPEDITIOUSLY AS POSSIBLE. WHERE THE GSL DOES NOT CHOOSE TO DIVEST, ALTERNATIVE STEPS NEED TO BE TAKEN TO PUT PUBLICLY-OWNED CORPORATIONS ON A BETTER SELF-FINANCING FOOTING.

THE INDUSTRIAL DEVELOPMENT POLICY SHOULD ALSO SET THE FRAMEWORK FOR FOREIGN INVESTMENT. IN ADDITION TO PROVIDING INCENTIVES FOR NEW INVESTMENT, PROBLEMS AFFECTING EXISTING INVESTMENTS IN SRI LANKA SHOULD BE ADDRESSED IN ORDER TO ASSURE A HOSPITABLE FOREIGN INVESTMENT CLIMATE. OTHER PRIVATE SECTOR ISSUES INCLUDE THE NEED TO REFORM TAXES TO INSURE THAT THEY ARE NOT A DISINCENTIVE TO PRIVATE SECTOR PRODUCTION, AND TO STREAMLINE REGULATORY PROCEDURES.

I WOULD LIKE TO MENTION SEVERAL ITEMS OF SPECIFIC CONCERN TO MY DELEGATION. THE FIRST IS "POST-MAHAWELI" REQUIREMENTS. THE MAJOR DAMS AND OTHER CONSTRUCTION WORK OF THE ACCELERATED MAHAWELI

DEVELOPMENT PROGRAM WILL SOON BE COMPLETED. HOWEVER, IT WILL TAKE A GREAT DEAL OF FOLLOW-ON WORK TO MAKE THE SETTLEMENT AREAS VIABLE AND PRODUCTIVE. FARMERS IN THE SETTLEMENTS MUST HAVE AN OPPORTUNITY TO RISE ABOVE SUBSISTENCE LEVELS. THEY WILL FIND AGRICULTURAL DIVERSIFICATION ESPECIALLY IMPORTANT, WITH PARTICULAR EMPHASIS ON SUBSIDIARY FIELD CROPS. ATTENTION ALSO SHOULD BE GIVEN TO DEVELOPING RURAL ENTERPRISES -- ESPECIALLY AGRIBUSINESS -- IN THE NEW SETTLEMENTS. AT THE SAME TIME, IN VIEW OF REPORTS OF OCCASIONAL ACTIVITIES BY SEPARATIST INSURGENTS IN SOME OF THE MORE REMOTE MAHAWELI AREAS, THE GOVERNMENT WILL HAVE TO GIVE CONSIDERATION TO PROVIDING APPROPRIATE SECURITY TO RESIDENTS OF THE NEW SETTLEMENTS.

AS CONCERNS DEVELOPMENT GENERALLY, WE ARE STRUCK BY THE FACT THAT, DESPITE THE NEED FOR REDUCED EXPENDITURES AND BETTER MANAGEMENT OF RESOURCES, THE GOVERNMENT'S OWN SIZE CONTINUES TO GROW. THERE ARE NOW 45 MINISTRIES AND OVER 160 AGENCIES WHICH MUST BE COORDINATED. WE WOULD URGE THE GOVERNMENT TO RATIONALIZE ITS GOVERNMENTAL ORGANIZATION, MERGING APPROPRIATE FUNCTIONS AND ELIMINATING THOSE WHICH ARE REDUNDANT. FOR EXAMPLE, FIVE MINISTRIES CURRENTLY HAVE AGRICULTURAL RESEARCH PROGRAMS TO COORDINATE, PARTICULARLY WITH RESPECT TO FARM SYSTEMS RESEARCH. IN ADDITION TO ORGANIZATIONAL SIMPLIFICATION, AGRICULTURE RESEARCH NEEDS TO BE BASED ON A SET OF ESTABLISHED PRIORITIES. THE GOVERNMENT'S DRAFT AGRICULTURE/FOOD/NUTRITION STRATEGY IS A GOOD START, BUT MORE NEEDS TO BE DONE.

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WE COMMEND THE STEPS THE GOVERNMENT HAS TAKEN THIS YEAR TO IMPROVE MAINTENANCE AND OPERATIONS OF CAPITAL INVESTMENTS. WE URGE EVEN GREATER EMPHASIS ON EFFECTIVE OPERATIONS AND MAINTENANCE SYSTEMS FOR THE IRRIGATION SCHEMES THROUGHOUT THE COUNTRY, WITH INCREASED FOCUS ON FARMER ORGANIZATIONS AND USER FEES. THE SAME CONCERNS FOR MAINTENANCE, USER FEES AND INTEREST RATES EXTEND TO HOUSING PROGRAMS AND UTILITIES.

TURNING TO A SIGNIFICANT SOCIAL ISSUE, SRI LANKA'S RATE OF NATURAL POPULATION INCREASE HAS REMAINED AT A RELATIVELY STABLE 2.1 PERCENT DURING THE PAST DECADE. DURING THIS TIME THE POPULATION GROWTH RATE DIPPED TO A LOW OF 1.4% DUE TO OUT-MIGRATION. HOWEVER, THIS SAFETY VALVE CANNOT BE COUNTED ON MUCH LONGER, AND A DOUBLING OF SRI LANKA'S POPULATION TO 33 MILLION OVER THE NEXT 33 YEARS IS IN PROSPECT.

WE WOULD URGE THE GOVERNMENT TO EXAMINE AFRESH THE DEMOGRAPHIC PERSPECTIVE, AND TO IMPROVE ITS PROGRAMS FOR THE PROMOTION OF CHILD SPACING AND THE DELIVERY OF NON-SURGICAL METHODS OF FAMILY PLANNING. WE ALSO RECOMMEND THAT THE GOVERNMENT ENCOURAGE GREATER COMMUNITY PARTICIPATION, PERHAPS BY USING LOCAL VOLUNTEERS TO DELIVER FAMILY PLANNING INFORMATION AND SERVICES.

FINALLY, I WANT TO SAY A FEW WORDS ABOUT THE SECURITY SITUATION. ITS EFFECTS ON THE ECONOMY AND ON DEVELOPMENT PROGRAMS CONCERN ALL OF US, BOTH BECAUSE OF THE TRAGIC LOSS OF LIFE AND BECAUSE SRI LANKA'S LONG TERM DEVELOPMENT IS JEOPARDIZED. INSURGENT MOVEMENT AND GOVERNMENT EFFORTS TO COUNTER IT ALREADY

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HAVE AFFECTED SOME DEVELOPMENT PROJECTS. WE HAD TO TERMINATE OUR ASSISTANCE TO A MARKET TOWN WATER SUPPLY PROJECT IN THE JAFFNA DISTRICT BECAUSE OF SECURITY CONCERNS, AND WE FIND INCREASING NUMBERS OF OUR PROJECTS DIRECTLY AFFECTED BY THE INSURGENCY.

WE ARE ALSO CONCERNED BY THE EXPANSION OF ECONOMIC DISRUPTION DUE TO THE ETHNIC DISTURBANCES. UNTIL RECENTLY, IT WAS CONFINED MAINLY TO THE NORTHERNMOST PART OF THE COUNTRY. LATELY, CLASHES IN THE EASTERN AND NORTH CENTRAL PROVINCES HAVE AFFECTED ECONOMIC ACTIVITY IN A MUCH GREATER AREA.

THE INSURGENCY HAS LED TO A GROWING SHARE OF RESOURCES BEING DEVOTED TO NATIONAL DEFENSE. THESE ADDITIONAL EXPENDITURES MUST BE FINANCED EITHER THROUGH INCREASED DEFICIT SPENDING OR REDUCTIONS IN THE FUNDS AVAILABLE FOR DEVELOPMENT PROGRAMS. NEITHER IS AN ATTRACTIVE ALTERNATIVE FROM A DONOR'S PERSPECTIVE.

WE ESTIMATE THAT, DUE TO SEPARATIST INSURGENT ACTIVITIES, ONE-FOURTH TO ONE-THIRD OF THE DOMESTIC MARKET MAY BE LOST IN THE NORTH AND EAST WHERE SUCH PROBLEMS AS CURFEWS AND LACK OF TRANSPORT, PRODUCTION INPUTS AND MARKETS, SEVERELY RESTRICT ECONOMIC ACTIVITY. FISHERIES PRODUCTION, FOR EXAMPLE, HAS DROPPED ABOUT 40 PERCENT WITH RESULTING HIGHER FISH PRICES IN THE MARKET PLACE. THE PROBLEMS IN THE EAST HAVE ALSO BROUGHT THE UNREST MUCH CLOSER TO AREAS WITH CONCENTRATIONS OF DONOR ACTIVITY, PARTICULARLY THE MAHAWELI.

MINISTER DEMEL ALREADY HAS TOUCHED ON THE PROBLEMS OF COMMUNAL VIOLENCE AND NATIONAL SECURITY. HOWEVER, WE ASK THAT HE ELABORATE FURTHER ON THIS TOPIC. WE WOULD APPRECIATE A REALISTIC ASSESSMENT

OF WHAT THE GOVERNMENT BELIEVES IT CAN CARRY OUT IN THE WAY OF DEVELOPMENT PROGRAMS, GIVEN THE CURRENT SECURITY SITUATION. HOW MUCH ATTENTION WILL THE GOVERNMENT DEVOTE TO DEFENSE-RELATED ISSUES AND AT WHAT COST TO THE DEVELOPMENT EFFORT? THE GOVERNMENT MIGHT WISH TO ADDRESS THE AID GROUP ON HOW IT MIGHT USE DONOR ASSISTANCE TO HELP BRING ABOUT OR IMPLEMENT A POLITICAL SOLUTION. ONE EXAMPLE WHICH COMES TO MIND IS HELP TO RESTORE PRODUCTIVE CAPACITY IN THE TROUBLED AREAS.

AS MY GOVERNMENT HAS STATED BEFORE, PUBLICLY AND PRIVATELY, THE COMMUNAL PROBLEM NEEDS A POLITICAL SOLUTION, ONE WHICH WILL PROVIDE ALL SRI LANKANS WITH THE OPPORTUNITY TO PARTICIPATE IN DEVELOPMENT AND RECEIVE ITS BENEFITS. I WISH TO REITERATE WHAT OUR GOVERNMENT HAS SAID IN THE PAST: A PURELY MILITARY APPROACH TO THE COMMUNAL/SECURITY PROBLEM NOT ONLY IS NOT FEASIBLE, BUT ALSO FAILS TO STRIKE AT THE ROOTS OF COMMUNAL ANTAGONISM WHICH HAVE SPAWNED THE CURRENT INSURGENCY. SRI LANKA HAS A JUSTLY ACCLAIMED REPUTATION FOR MEETING THE BASIC HUMAN NEEDS OF ITS PEOPLE WHILE FOLLOWING ECONOMIC POLICIES WHICH PROMOTE GROWTH AND DEVELOPMENT. WE HOPE THAT THESE POLICIES WILL BE VIGOROUSLY APPLIED AND WILL NOT BE ERODED BY THE SECURITY SITUATION OR COMMUNAL TENSIONS.

ANE/ASIA/PNS, JNGUNNING, 6/11/85, #1429c

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UNCLASSIFIED
Department of State

INCOMING
TELEGRAM

PAGE 01 COLOMB 03873 071023Z 6366 058595 AID7448
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- AREA. UNQUOTE.

ACTION OFFICE ASPN-02
INFO AAAS-01 ASDP-02 ASPD-03 ASTR-02 PPR-01 RELO-01 TELE-01
MAST-01 PRE-06 /020 A1 11-7

- F. PARA 16, LINE 1: DELETE QUOTE TERRORISM UNQUOTE
- AND*SUBSTITUTE QUOTE SEPARATIST INSURGENT ACTIVITIES
- UNQUOTE.

INFO LOG-00 NEA-07 /007 W
-----042140 0710257 /38

- G. PARA 20, LINE 5: FOLLOWING THE WORD QUOTE
- BENEFITS UNQUOTE, ADD THE FOLLOWING SENTENCE QUOTE
- I CAN ONLY REITERATE WHAT OUR GOVERNMENT HAS SAID
- IN THE PAST: A PURELY MILITARY APPROACH TO THE
- COMMUNAL/SECURITY PROBLEM NOT ONLY IS NOT FEASIBLE,
- BUT ALSO FAILS TO STRIKE AT THE ROOTS OF COMMUNAL
- ANTAGONISM WHICH HAVE SPANNED THE CURRENT INSURGENCY.
- UNQUOTE.

O 071013Z JUN 85
FM AMEMBASSY COLOMBO
TO SECSTATE WASHDC IMMEDIATE 1148

UNCLAS COLOMBO 03873

AIDAC

E.O. 12356: N/A
SUBJECT: PROPOSED U.S. STATEMENT FOR SRI LANKA
- AID GROUP MEETING

J. THIS MESSAGE HAS BEEN COORDINATED WITH THE EMBASSY
ECONOMIC AND POLITICAL OFFICERS AND CLEARED BY THE
DCM. REED

REF: (A) COLOMBO 3816, (B) STATE 157360

1. MISSION PROPOSES THAT THE FOLLOWING CHANGES
TO THE OFFICIAL STATEMENT FOR SRI LANKA AID
GROUP MEETING BE MADE IN ADDITION TO THOSE SENT
IN REF (A).

2. CHANGES CORRESPOND TO THE PARAGRAPHS OF TEXT
IN REF (B).

- A. PARA 4, SECOND TO LAST LINE: DELETE QUOTE
- OF ABOUT 25 PERCENT UNQUOTE. COMMENT: THE
- RUPEE SHOULD BE DEVALUED BUT STATING A
- PERCENTAGE MAY CAUSE NEEDLESS QUIBBLING.
- B. PARA 9, LAST LINE: FOLLOWING QUOTE IN THE
- NEW SETTLEMENTS UNQUOTE ADD THE FOLLOWING SENTENCE
- QUOTE. AT THE SAME TIME, IN VIEW OF REPORTS OF
- OCCASIONAL ACTIVITIES BY SEPARATIST INSURGENTS
- IN SOME OF THE MORE REMOTE MAHAWELI AREAS, THE
- GOVERNMENT OF SRI LANKA WILL HAVE TO GIVE
- CONSIDERATION TO PROVIDING APPROPRIATE SECURITY
- TO RESIDENTS OF THE NEW SETTLEMENTS. UNQUOTE.
- C. PARA 8. DELETE ENTIRE PARAGRAPH AND
- SUBSTITUTE QUOTE THE INDUSTRIAL DEVELOPMENT
- POLICY SHOULD ALSO SET THE FRAMEWORK FOR FOREIGN
- INVESTMENT. IN ADDITION TO PROVIDING INCENTIVES
- FOR NEW INVESTMENT, PROBLEMS OF EXISTING
- INVESTMENTS IN SRI LANKA SHOULD BE ADDRESSED IN
- ORDER TO ASSURE A HOSPITABLE FOREIGN INVESTMENT
- CLIMATE OTHER PRIVATE SECTOR ISSUES INCLUDE THE
- NEED TO DETERMINE REGULATORY PROCEDURES AND TO
- REFORM THE TAX SYSTEM. SRI LANKA RELIES HEAVILY
- ON INDIRECT TAXES, WHICH HAVE A DISINCENTIVE EFFECT
- ON THE PRIVATE SECTOR BY FOCUSING ON PRODUCTION AND
- TURNOVER RATHER THAN PROFITS. UNQUOTE.
- D. PARA 15, LINE 5: DELETE QUOTE THE TERRORIST
- AND COUNTER-TERRORIST UNQUOTE AND SUBSTITUTE
- QUOTE INSURGENT MOVEMENT AND GOVERNMENT EFFORTS TO
- COUNTER IT. UNQUOTE.
- E. PARA 16. DELETE ENTIRE PARAGRAPH AND SUBSTITUTE
- QUOTE WE ARE ALSO CONCERNED BY THE EXPANSION OF
- ECONOMIC DISRUPTION DUE TO THE ETHNIC DISTURBANCES.
- UNTIL RECENTLY, IT WAS CONFINED MAINLY TO THE
- NORTHERNMOST PART OF THE COUNTRY. LATELY, CLASHES
- IN THE EASTERN PROVINCES AND NORTH CENTRAL PROVINCES
- HAVE AFFECTED ECONOMIC ACTIVITY IN A MUCH GREATER

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TELEGRAM

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ACTION AID-00

ACTION OFFICE ASPN-02
INFO AAAS-01 ASEM-02 ASDP-02 PFPB-02 PPQC-01 ASTR-02 ES-01
 AAID-01 RELO-01 MAST-01 1016 A2 1206

INFO LOG-00 NEA-07 /007 W

-----345310 060459Z /38

P 060448Z JUN 85
FM AMEMBASSY COLOMBO
TO SECSTATE WASHDC PRIORITY 1116

UNCLAS COLOMBO 03816

AIDAC

E. O. 12356: N/A
SUBJECT: PROPOSED U. S. STATEMENTS FOR SRI LANKA AID
 GROUP MEETING

REFS: (A) STATE 157360, (B) STATE 158752

1. MISSION HAS REVIEWED PROPOSED U. S. GENERAL STATEMENT AND PLEDGING STATEMENT TRANSMITTED REFEELS. WE CONCUR WITH THE STATEMENTS, FINDING THEM TO BE APPROPRIATE EXPOSITIONS OF USG POSITION. WE HAVE TWO SUGGESTED REWORDINGS:

A. THE FINAL SENTENCE OF THE GENERAL STATEMENT WOULD BETTER SUMMARIZE USG VIEWS IF IT READ QUOTE WE HOPE THAT THESE POLICIES WILL BE VIGOROUSLY APPLIED AND WILL NOT BE ERODED BY THE SECURITY SITUATION OR COMMUNAL TENSIONS UNQUOTE.

B. IN THE PLEDGING STATEMENT IN THE PARAGRAPH REFERRING TO ONGOING AND NEW PROJECTS, THE WORDS QUOTE COMMUNITY DEVELOPMENT UNQUOTE SHOULD BE DELETED AND SUBSTITUTED THE WORDS QUOTE IMPROVED DEVELOPMENT MANAGEMENT AND COORDINATION UNQUOTE. REED

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OTHER DONOR ASSISTANCE

Sri Lanka's development strategy combines equity and growth considerations, and has been very attractive to donor countries and institutions. At the Aid Group meeting in Paris, June 1984, the World Bank reported that commitments for project aid during 1985 were likely to be about \$541 million, including \$168 million for the Accelerated Mahaweli Program. The aid community made commitments of \$3,583 billion to Sri Lanka from 1972 through 1983, of which \$2,287 billion was disbursed during that period. (\$962 million of the aid commitments was for Mahaweli). Bilateral donors of over \$100 million included Canada, West Germany, Japan, the Netherlands, Sweden, the U.K. and the U.S. Sri Lanka is one of only six countries to which Finland provides aid. India is a significant donor. Sri Lanka also receives assistance from Saudi Arabia, the UAE, and the various other Arab funds. The EEC and IFAD are active in Sri Lanka as are the various UN agencies. Sri Lanka in 1982 obtained three IDA loans for \$86 million; an IBRD loan for \$42.7 million, and five ADB loans totalling \$60.6 million.

Gross foreign aid disbursements represented approximately 8.7% of GDP in 1984. Expressed in terms of government expenditures, concessional project aid receipts were expected to finance about 63% of the capital budget in 1984. The Government projects a gradual increase in foreign aid disbursements over the next few years. Commitments, however, are likely to decline as Mahaweli pledges are completed.

The Accelerated Mahaweli Program is of such a magnitude (over \$2 billion) and with so many donors, that the IBRD played a special role in coordinating aid inputs during its inception. The Program was the major topic of discussion at annual Aid Group meetings for several years. The coordination role now is handled competently by the GSL itself through the Mahaweli Development Authority and the Ministry of Finance and Planning which has responsibility for the receipt and coordination of foreign aid.

The Government does a good job in general of coordinating the receipt of foreign aid. Donors would like to see the GSL do a better job of monitoring its expenditures. For example, the machinery for ensuring prompt filing of reimbursement claims needs strengthening. However, the Government does a competent job of planning new activities and approaching donors according to their interests. It encourages donors to coordinate on specific projects in addition to the annual IBRD-sponsored consortium meeting. There is a monthly donors meeting in Colombo which enables donor representatives to become acquainted and arrange further meetings on topics of mutual interest.

USAID maintains close relationships on a sectoral basis with other donors directly related to an AID project. It maintains general contact with donors involved in the same sector, and consults them when examining possible new projects.

SRI LANKA AID GROUP

The Sri Lanka Aid Group consists of thirteen bilateral and four multi-lateral members as listed in the table below. Official observers at recent meetings have included Belgium, India, Italy, Switzerland, IFAD and DAC/OECD. The Aid Group, chaired by the World Bank, normally meets once a year to review Sri Lanka's economic development progress and prospects, and to give the international donor community an opportunity to "pledge" new aid for the coming year. Donors made the following pledges at Sri Lanka Aid Group meetings:

<u>AID Group Members</u>	<u>PLEDGES</u>				
	<u>\$ Million</u>				
	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
<u>1. Bilateral</u>					
Australia	2.1	8.2	8.1	4.5	4.9
Austria	--	--	--	--	--
Canada	70.2	30.8	12.6	19.6	30.8
Denmark	--	2.3	.4	8.0	2.3
Finland	1.0	3.3	4.6	7.8	8.6
France	15.6	25.6	19.0	--	9.5
Germany	13.3	186.6	6.0	10.8	10.6
Japan	105.2	96.7	97.1	29.9	99.4
Netherlands	35.8	16.4	21.2	13.3	12.6
Norway	10.7	8.7	10.2	9.4	10.0
Sweden	22.8	22.1	21.9	26.7	3.7
United Kingdom	6.2	--	--	.1	44.5
United States ^{1/}	<u>66.5</u>	<u>70.3</u>	<u>85.2</u>	<u>94.2</u>	<u>85.9</u>
Subtotal	349.4	471.0	280.3	224.3	322.0
<u>2. Multilateral</u>					
IBRD	151.5	161.0	126.9	56.7	110.0
ADB	55.0	50.5	45.4	51.0	52.0
EEC	9.9	27.8	9.2	.2	12.2
UN	<u>13.4</u>	<u>12.2</u>	<u>13.2</u>	<u>18.0</u>	<u>30.9</u>
Subtotal	129.8	251.5	194.7	125.9	205.0
Total	479.2	722.5	475.0	350.2	527.0

^{1/} Actual U.S. Assistance: FY 80-\$59.1, FY 81-\$71.7 (plus a \$25 HIG), FY 82-\$71.7, FY 83-\$81.4 (plus a \$10 HIG).

Data Source: IBRD Sri Lanka Aid Group Reports
WD #1358c 5/3/85

SRI LANKA - EXPENDITURES IN \$ MILLIONS (SOURCE: OECD; February 1984)(520c)

<u>DAC COUNTRIES</u>	<u>TOTAL ODA NET</u>									
	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
AUSTRALIA	4.5	9.0	2.5	2.5	5.9	5.0	3.6	9.8	11.5	7.9
AUSTRIA	-	-	0.0	0.0	0.0	0.1	0.1	0.0	0.1	0.1
BELGIUM	0.0	0.0	0.1	0.0	0.1	0.5	0.3	0.2	0.3	0.4
CANADA	7.1	9.4	13.1	16.2	25.2	17.3	29.3	32.8	33.4	36.1
DENMARK	0.4	0.2	0.7	0.9	2.0	0.0	5.2	2.9	0.7	2.4
FINLAND	0.0	0.1	0.0	-	0.1	0.2	0.4	2.1	3.4	4.7
FRANCE	3.6	4.5	6.3	0.7	2.9	6.2	6.5	17.2	2.0	5.1
GERMANY, F.R.	18.8	17.2	11.1	9.6	33.5	31.3	19.1	9.6	24.4	42.6
ITALY	-0.3	1.1	-0.2	0.8	-0.1	0.1	0.1	0.2	-0.3	0.1
JAPAN	10.5	16.1	10.9	18.6	39.5	40.0	44.8	49.1	61.6	73.1
NETHERLANDS	0.5	4.1	6.2	12.0	32.1	21.2	22.7	49.5	21.5	25.4
NEW ZEALAND	0.1	1.5	0.7	0.2	0.2	0.1	0.1	0.1	0.0	0.0
NORWAY	0.1	0.3	0.3	3.8	5.2	7.9	11.4	8.1	14.7	11.7
SWEDEN	3.8	9.3	9.0	11.7	13.7	35.4	23.1	22.7	25.2	28.3
SWITZERLAND	0.0	0.1	0.2	0.2	0.3	0.7	1.2	1.2	2.5	4.5
UNITED KINGDOM	2.1	4.1	8.1	5.1	14.9	26.0	73.3	50.4	55.5	42.3
<u>UNITED STATES</u>	<u>7.0</u>	<u>23.0</u>	<u>26.0</u>	<u>37.0</u>	<u>41.0</u>	<u>40.0</u>	<u>55.0</u>	<u>31.0</u>	<u>49.0</u>	<u>58.0</u>
TOTAL DAC	58.2	100.0	94.9	119.4	216.3	232.0	296.1	286.8	305.4	342.6
<u>MULTILATERAL</u>										
AS.D.B.SP.F.	2.8	6.1	4.3	9.2	24.0	9.2	5.8	9.3	16.8	28.7
E.E.C.	2.6	12.2	4.9	6.0	6.3	4.4	6.8	20.4	12.5	13.5
IDA	10.9	13.6	5.0	11.1	11.2	12.4	19.7	27.8	53.6	59.3
I.F.A.D.	-	-	-	-	-	1.2	1.8	3.5	2.2	1.8
IMF TRUST FUND	-	-	-	-	50.8	38.4	32.7	0.5	-	-
UNDP	2.7	4.7	4.7	4.0	4.8	6.3	7.7	7.5	7.9	7.8
UNTA	0.6	0.7	0.8	1.1	1.3	1.8	0.3	1.9	1.3	2.0
UNICEF	1.3	1.6	1.1	1.4	1.9	3.6	6.3	3.6	3.0	2.6
UNFPA	-	-	-	0.6	-	-	1.1	1.5	1.5	0.7
WFP	<u>0.6</u>	<u>7.6</u>	<u>15.0</u>	<u>18.2</u>	<u>0.5</u>	<u>4.3</u>	<u>1.9</u>	<u>1.2</u>	<u>6.1</u>	<u>4.1</u>
TOTAL MULT	21.5	46.5	35.8	51.6	100.8	81.6	84.1	77.2	104.9	120.5
TOT DAC & MULT	79.7	146.5	129.7	171.0	317.1	313.6	380.2	364.0	410.3	463.1

F

SRI LANKA AID GROUP MEETING

June 20-21, 1985

Mr. Eugene S. Staples, Head of Delegation
Deputy Assistant Administrator
Bureau for Asia and Near East, A.I.D.

Mr. Frank D. Correl
Director
USAID Mission to Sri Lanka

Mr. John N. Gunning
Sri Lanka Desk Officer
Office of Pakistan/Nepal/Sri Lanka Affairs
Bureau for Asia and Near East, A.I.D.

Mr. Ross Rodgers
State Department Representative
for Sri Lanka and India

WD #1380c

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SUMMARY AND CONCLUSIONS

- i. After almost ten years of low growth, Sri Lanka introduced a new development strategy during the late 1970s, and the economy made good economic progress in several ways; output, employment and investment recorded substantial increases. GDP grew at 5.7% per annum in real terms between 1977 and 1984. The rapid growth in paddy output was most impressive, with the result that rice imports declined from an average of 33% of total rice consumption during 1970-77 to only 12% during 1978-83. Today the country has virtually reached self-sufficiency in rice. The ambitious public investment program, dominated by the massive Mahaweli irrigation and power development, was equally noteworthy; it was designed to create new sources of long-term growth. In support of this program, the country secured unprecedented levels of external aid.

- ii. Some of the policies which made these achievements possible, however, also led to serious financial imbalances. For example, as the public investment program gained momentum, it grew beyond the country's resource availabilities, thus contributing to unsustainable budgetary and balance of payments deficits and to undesirable levels of foreign commercial borrowing. More importantly, the imbalances in the budget and in the balance of payments were aggravated by an inadequate resource mobilization effort by the public sector and by the existence of an overall policy environment which was not conducive to growth in several major subsectors of the economy, and especially the export sector. Exchange rate policy was of primary importance. Following the unification and depreciation of the exchange rate in 1977, the Sri Lankan rupee has more or less continuously appreciated in real terms, thereby moving relative incentives in favor of non-traded activities and against sectors such as agriculture and industry. Within agriculture, paddy production was the exception: it was not taxed directly; prices were allowed to rise to world market levels; inputs were subsidized; other government spending such as Mahaweli directly assisted paddy; and it received substantial research and extension assistance. Other agricultural subsectors performed relatively poorly. This was especially true of the tree crop sector, which was subject to high export taxes and continued weak management in the state plantations. Industrial growth was also low. Although import tariffs were used to provide higher protection to manufacturing, the growth opportunities created by this inward-looking policy were limited by the small size of the domestic market. Moreover, the tariff structure protected existing firms but discouraged the creation of new industries, while the performance of publicly owned manufacturing enterprises, which still contribute about 40% of manufacturing value added, was particularly poor. Export growth based largely on tourism and garments was sporadic. Excluding export earnings from the latter two activities, the real growth rate of exports during 1979-84 was barely 2.1% per year. Export earnings have remained concentrated on a few products, with tea and rubber alone accounting for half of total merchandise export value in 1984.

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iii. Despite the considerable political and social unrest, real GDP grew at 5% in 1984, matching the 1983 growth rate. After several years of precarious financial conditions, 1984 saw a significant reduction in both the external and internal deficits. As a share of GDP, the overall budget deficit declined from 13.4% in 1983 to 10.2% in 1984, while the current account deficit in the balance of payments declined from 12.4% in 1983 to 3.7% in 1984. Net international reserves rose by \$305 million. These achievements were partly the result of Government policy, including the adoption of restrictive credit policies towards the private sector, the introduction of new revenue raising measures and the containment of public spending. Yet the dominant factor in explaining these developments was tea; export earnings from tea rose by \$267 million or the equivalent of 4.4% of GDP, while government revenue from tea export taxes rose by Rs 2,794 million, the equivalent of 1.8% of GDP.

iv. The sudden decline in tea prices during early 1985 underscores the continued vulnerability of the Sri Lankan economy and hence the need to pursue policies which will stimulate growth in new activities. The two primary areas of growth in the recent past, viz., paddy and public investment supported by large concessionary foreign capital inflows, are expected to slow. As rice self-sufficiency is now being reached, this sector is likely to be a less important source of growth in the future. In addition, public investment is unlikely to -- and indeed should not -- expand very rapidly, in part because concessionary aid inflows are expected to level off. Yet, if Sri Lanka is to absorb the yearly addition to the active labor force and raise welfare levels, it is vital to maintain output growth rates of the order of 5% per annum. The primary issue facing the country, therefore, is to design and implement policies which will generate growth in alternative activities, especially exports. In addition, if growth is to be attained within a sustainable financial framework, issues of investment strategy and domestic resource mobilization will also need to be addressed.

v. The Government is well aware of these problems and, as demonstrated by the 1985 budget, has continued the process of policy reform. The 1985 budget introduced three new policy initiatives related to trade taxes, namely import tariff reform, a change in export taxes on tree crops, and a proposal to establish stabilization funds for tea and rubber. The import tariff reform is the first step in a phased program to reduce the variance in effective protection and lower the average level of protection. The Government showed considerable resolve in pushing forward with this reform despite much internal opposition. The change in tree crop taxation, which accompanied the introduction of the Medium Term Investment Program for the state plantations, resulted in an overall reduction in the tax burden on tree crops and thus helped restore producer incentives in the sector. A decision was also made to establish stabilization funds for tea and rubber as a countercyclical measure designed to reduce macro-economic fluctuations in an economy dependent on primary commodity exports with wide price fluctuations. In addition to these budgetary actions, the Government's report on a National Agricultural, Food and Nutrition Strategy lays out a framework for important reforms in the support services which would greatly assist in creating conditions for

broader-based agricultural growth. Also, to help develop a consistent industrial policy framework, the Government has formed a high level Industrial Policy Committee, and it has continued to press hard to initiate reform of the public enterprise sector. These are major steps in moving towards an incentive framework which will allocate and utilize resources more efficiently. More needs to be done, however, if the Government is to achieve its objective of a rate of economic growth of at least 5% per annum in the coming years.

vi. Economic projections for Sri Lanka are more than normally uncertain because of the current social and political tensions in the country. The report's projections assume that substantial progress will be made in resolving the communal conflict. The analysis suggests that a 5% per annum rate of economic growth is feasible and the current comfortable international reserves' position provides a good background against which to introduce further policy reform. It is recognized, however, that the volatile domestic situation may make the type of policy shifts advocated here difficult to implement. This argues for patience, but it does not negate the importance of continuing the process of reform.

vii. Recent growth rates in agriculture, when import substitution in rice was the major driving force, are unlikely to be repeated. Nevertheless, the rehabilitation of the tree crop sector together with a determined effort at agricultural diversification and continued but slower growth in paddy should lead to a fairly high rate of expansion of some 3.6% per year during the next five years. The annual real growth rate of industry, on the other hand, should accelerate from 3.5% during 1979-84 to 4.8% during the next five years based on several anticipated developments. Processing traditional exports, which constitutes about one quarter of value added in industry, should grow at 2 to 3% per annum, as opposed to stagnation in the past. Exports of manufactures, which make up some 15% of industrial value added, should increase at 10% per annum given adequate incentives. Other industrial output should expand at 4.5 to 5.0% per annum, on the expectation that public manufacturing enterprises will be rationalized and the demand for domestic manufactures will increase in response to rising real incomes and an appropriate exchange rate policy.

viii. The diversification of growth in both the agricultural and industrial sectors will need to focus on export markets and efficient import substitution. This means, in turn, providing appropriate incentives -- the exchange rate and trade taxes cum subsidy policies; providing support services including research and extension; developing infrastructure, especially roads and rehabilitating existing assets; and, pursuing institutional reforms, especially in respect of public enterprises and financial markets. It must be added that the success of this strategy depends crucially upon continued growth in, and unrestricted access to, world export markets.

ix. It was mentioned earlier that the Government has initiated some significant reforms in agriculture designed to revitalize parts of the sector. If these initiatives are to yield maximum benefits, they need to be set within

an overall strategy designed to encourage the most efficient use of land resources. The investment in Mahaweli is beginning to open up new areas of irrigated land and the country's level of rice imports is minimal. Sri Lanka is, therefore, well placed to diversify into other crops without sacrificing the Government's prime objective of rice self-sufficiency. The challenge will be to create a policy framework which encourages farmers to increase yields from existing crops and to move land out of paddy in some areas into alternative crops. The latter development is more likely to occur where the return to producing alternative crops is high and the domestic policy biases in favor of paddy are reduced. This will take time because farmers often perceive paddy as an "insurance" crop, i.e., it does not have to be traded to provide nutrition, farmers are familiar with optimal cultivation practices, and Government policy is designed to support paddy.

x. A program of reforms is required that reduces the risk and raises the relative return to the farmer of moving land into its most productive use. Such a program will include incentive, support service and institutional components. The first step should be to restore producer incentives by allowing international prices to have a greater influence on the relative returns to different crops with due regard to stabilization objectives. This would entail restructuring taxation and subsidy policies around a more neutral framework, which includes cost recovery on publicly provided inputs such as irrigation water or fertilizer. This would also necessarily imply broadening the tax base in agriculture in order to equalize the tax effects on different crops. Second, there is a need to renew efforts to channel more resources into the necessary support framework. Improved research and extension services for a wider variety of crops and the rehabilitation and maintenance of the infrastructure in rural areas appear to be high priorities. In addition, whenever the opportunity arises, institutional reform should be pressed forward, both to reduce direct Government involvement in production, marketing or distribution and to consolidate and rationalize the remaining administrative structure.

xi. As indicated, the Government has also begun to tackle in earnest several important constraints affecting the industrial sector. These initiatives must now be pursued further. The phased process of tariff reform should be continued and certain anomalies in the first stage corrected; these include the exceptions which were allowed as well as the increase in Business Turnover Taxes payable on imports which partially offset the reduction in import duties. Concrete action to reform the public enterprise sector should be initiated early since this process is likely to take time. Above all it is crucial for the Government to establish and maintain the exchange rate at a level which will keep Sri Lanka internationally competitive in a wide range of exporting and import substituting activities.

xii. In pursuit of the growth objective it is also crucial that financial stability be maintained. To that end, the ratio of investment to GDP will have to be reduced from the average of 29.4% during 1980-84 to around 26.0% during the next five years and the national savings rate will have to increase

from 16.4% of GDP during 1980-84 to close to 20.0%. The reduction in the investment rate and the increase in the national savings rate will depend to a large extent on budgetary policies. Private investment is projected to increase as a share of GDP from 12.0% in 1980-84 to close to 14.0% during 1985-89 in response to the growth policies discussed above. Public investment will therefore have to be reduced from more than 17.0% during 1980-84 to about 12.0% during 1985-89, a target which the Government itself has accepted. On the savings side, it is important to maintain private savings at the level achieved in recent years; this means following a more flexible interest rate policy which offers a positive real rate of interest so as to attract private saving. Budgetary savings have been negative in most recent years. This is projected to change as a result of a combination of expenditure cuts and revenue raising measures. Thus, budgetary savings are expected to average 3% of GDP during the coming years. Reducing current spending may be difficult; there is a clear need to raise public sector salaries and the Government has begun to provide increased allocations for much needed spending on operation and maintenance. While several categories of current spending are fixed obligations and cannot be cut, there remain within the Sri Lankan budget several items of expenditure in the areas of subsidies, transfers and advance account payments which can be cut without efficiency loss. There is a clear need to review the desirability of continuing to subsidize producer inputs, of providing transfers and advance account payments to inefficient public corporations which cannot be expected to pay back, and there are many instances where increased reliance on user charges must be pursued. Nevertheless, even if the Government succeeds in controlling current spending, there will continue to be a need to raise revenues and restructure the tax system in order to reach the savings target. The challenges to continued good budgetary management are illustrated by developments during early 1985. The unexpected decline in tea prices may make it difficult to reach the 1985 budget revenue targets. At the same time, the Government continues to be under a great deal of pressure to admit new expenditures, partly due to the windfall accumulation of reserves during 1984.

xiii. The attainment of the 5% growth objective also rests on some important assumptions regarding external factors. The accumulation of reserves which occurred in 1984 has established a base from which the immediate balance of payments outlook is healthy under most scenarios. Even with a successful export drive as assumed in this report, however, Sri Lanka will continue to require substantial amounts of foreign assistance over the medium term. In the past the large resource gaps arising from successive budget deficits and slow export growth were financed by rapidly growing remittances and especially by the increased use of foreign concessionary capital made available by donors. Remittances are unlikely to continue their past growth and concessionary capital has become much scarcer. The projections assume that remittances remain constant in real terms. Official grants are projected to decline even in current prices, while commitments of new concessionary loans remain constant in real terms at the current level of about \$300 million. There is, however, projected to be some real increase in non-concessionary financing from official sources, so that total commitments from official

sources, loans and grants, are projected to remain constant in real terms. In the coming years the Sri Lankan economy will be forced to adjust to much smaller resource gaps than in the past and to rely partly on commercial borrowing to fill those gaps.

xiv. The balance of payments projections in this report depend, above all, on the restoration of international competitiveness; the significant real appreciation of the Sri Lankan rupee since 1977 must be reversed. In volume terms export growth is projected to exceed import growth, although this will not be the case in current prices during the next five years because of deteriorating terms of trade. The bulk of external finance needed during the next few years to cover the current account deficit, amortization, repayments to the IMF and the addition to reserves, would come from official sources on highly concessional terms. New commitments from these sources, loans and grants, would have to rise from \$460 million in 1984 to \$600 million by 1988. It should be noted that this level of commitments implies no growth in real terms. Commitments of official assistance have declined substantially from the peak of \$800 million in 1981. In the past two years they have averaged about \$450 million a year, partly because both Government and donors made a conscious effort to limit the introduction of new projects in a public investment program which had grown beyond the country's absorptive capacity. Current indications are that the aid donors are likely to make new commitments amounting to about \$500 million during 1985. For 1986 we would also recommend to the donors a level of new aid commitments of the order of \$500-550 million. This level of support is a vital component in the overall strategy of restructuring the Sri Lankan economy at the same time that foreign commercial borrowing is contained at a manageable level. Areas most urgently in need of support include rehabilitation of existing irrigation schemes, completion of downstream work in Mahaweli, rehabilitation of the road network, power transmission and generation, and telecommunications. Financing of local expenditures in support of the Government's own efforts to raise public sector savings and reduce the overall budget deficit should also receive high priority.

xv. Together with the strengthening of Sri Lanka's export sector the country would also gradually become creditworthy for increasing levels of commercial borrowing. The balance of payments projections in this report assume that new commitments of private loans rise from \$130 million in 1985 to about \$285 million by 1988. A substantial portion of this commercial borrowing would be related to cofinancing requirements for some large projects with good economic justification, such as the major upcoming power projects.

xvi. With a concerted effort to build up exports, strong support from donors and prudence in the use of commercial debt, Sri Lanka's debt servicing burden will be manageable. The public debt service ratio implicit in the balance of payments projections in this report, including IMF charges and repurchases, rises to 18.8% in 1987 but then declines to 18.0% in 1988 and 15.1% in 1994. The most crucial element in balance of payments management is to ensure that the export growth targets are achieved. If the Government were

to maintain a high rate of investment and GDP growth through increased reliance on foreign borrowing to compensate for the shortfall in export receipts, the external debt service ratio would quickly rise to unacceptable levels, soon restricting the country's access to voluntary foreign capital inflows. On the other hand, if the Government reacts to the weaker export performance by curbing investment and import growth and reducing the growth of output, incomes and employment, the rate of growth of total consumption would eventually be reduced severely to unacceptably low levels, jeopardizing much of the economic progress made during the past few years.

xvii. In sum, attaining the growth targets postulated in this report in the context of internal and external financial stability, entails a policy agenda for the Government which includes:

- (1) an appropriate exchange rate policy and changes in trade taxes and subsidy policies to create a producer incentives' framework which is more neutral between different activities: this includes, among others, a further review of tree crop taxation, and continuation of the phased process of tariff reform;
- (2) increased emphasis on support services, including research and extension, for broad-based agricultural growth;
- (3) investment in infrastructure such as roads, rehabilitation and power;
- (4) concrete action towards public enterprise reform;
- (5) a public investment program not exceeding around 12% of GDP; and
- (6) an increase in public savings to around 3% of GDP through a combination of expenditure cuts and revenue increases.

To complement the above, the donor community should consider:

- (1) maintaining total official commitments roughly constant in real terms in the future, and in the range of \$500-550 million during the coming year;
 - (2) giving priority to meeting needs related to rehabilitation of existing irrigation schemes, completion of downstream work in Mahaweli, rehabilitation of the road network, power transmission and distribution, and telecommunications;
 - (3) continuing to finance local currency expenditures; and
 - (4) continuing to provide technical assistance to the Government.
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ACTION AID-00

COLOMB 03J21 00 OF 03 160647Z 7393 044382 AID0272
CONCENTRATIONS OF DONOR ACTIVITY, PARTICULARLY THE
MAHAWELI REGION.

ACTION OFFICE GCAS-01
INFO ASPN-02 GC-01 GCFL-01 ASPD-03 ASTR-02 STAG-02 SAST-01
ENGR-01 ES-01 AGRI-01 STFA-01 RELO-01 HAST-01
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COLOMBO 03321

AIDAC

E.O. 12356: N/A
SUBJECT: SRI LANKA AID GROUP MEETING

REF: COLOMBO 0729

1. WE HAVE BEEN ADVISED INFORMALLY BY THE GSL THAT THEIR DELEGATION WILL BE HEADED BY RONNIE DE MEL, MINISTER OF FINANCE AND PLANNING AND THAT THE DELEGATION WOULD INCLUDE THE MINISTRY'S DR. W. M. TILAKARATNE, SECRETARY; DR. LLOYD FERNANDO, DIRECTOR, NATIONAL PLANNING DIVISION; AND AKIEL MOHAMED, DIRECTOR, EXTERNAL RESOURCES DEPARTMENT; AND POSSIBLY DR. W. RASAPUTRA, GOVERNOR, CENTRAL BANK.

2. WE SUGGEST THAT CONSIDERATION BE GIVEN TO RAISING FOLLOWING MAJOR PROBLEMS BY U.S. AT THIS YEAR'S MEETING:

A.1. THE SECURITY SITUATION AND ITS EFFECT ON DEVELOPMENT PROGRAMS SHOULD BE A PRINCIPAL TOPIC OF DISCUSSION. THE TERRORIST AND COUNTER-TERRORIST CAMPAIGNS HAVE AFFECTED SOME DEVELOPMENT PROJECTS ALREADY. THE U.S. DELEGATION COULD POINT TO THE MARKET TOWN WATER SUPPLY PROJECT (383-0063) WHICH A.I.D. HAD TO TERMINATE BECAUSE THE GSL COULD NOT PROVIDE ASSURANCES THAT SECURITY IN THE JAFFNA DISTRICT WOULD BE ADEQUATE FOR WORK TO CONTINUE (SEE REF. A FOR MORE DETAIL). FOR THE MOST PART, THE SERIOUS ECONOMIC DISRUPTION HAS BEEN CONFINED UNTIL RECENTLY TO THE NORTHERNMOST PART OF THE COUNTRY WHICH CONTRIBUTES ONLY A SMALL SHARE OF TOTAL GDP. HOWEVER, THE ETHNIC DISTURBANCES IN THE EASTERN PROVINCE HAVE NOW DISRUPTED ACTIVITIES IN AN AREA MORE IMPORTANT ECONOMICALLY.

A.2. ANOTHER ASPECT OF THIS PROBLEM IS THE GROWING SHARE OF RESOURCES DEVOTED TO NATIONAL DEFENSE. THE ORIGINAL 1985 DEFENSE BUDGET OF RS. 3.4 BILLION ALREADY HAS INCREASED TO RS. 4.9 BILLION AND NOW REPRESENTS APPROXIMATELY 10 PERCENT OF THE ESTIMATED TOTAL BUDGET FOR 1985. THESE ADDITIONAL EXPENDITURES CAN BE FINANCED EITHER THROUGH INCREASING THE DEFICIT OR REDUCING THE FUNDS AVAILABLE FOR DEVELOPMENT PROGRAMS. NEITHER IS A VERY ATTRACTIVE ALTERNATIVE FROM A DONOR'S PERSPECTIVE.

A.3. THE MISSION ESTIMATES THAT DUE TO TERRORISM, ONE-FOURTH TO ONE-THIRD OF THE DOMESTIC MARKET MAY BE LOST IN THE NORTH AND EAST WHERE CURFEWS AND LACK OF TRANSPORT PRODUCTION INPUTS AND MARKETS, ETC., SEVERELY RESTRICT ECONOMIC ACTIVITY. FISHERIES PRODUCTION, FOR EXAMPLE, IS DOWN ABOUT 40 PERCENT WITH RESULTING HIGHER FISH PRICES IN THE MARKET PLACE.

A.4. THE PROBLEMS IN THE EAST HAVE ALSO BROUGHT THE UNREST MUCH CLOSER TO THE GEOGRAPHIC ZONES WITH

A.5. THE SRI LANKANS SHOULD BE ASKED TO PROVIDE A REALISTIC ASSESSMENT OF WHAT THEY BELIEVE CAN BE CARRIED OUT IN THE WAY OF DEVELOPMENT PROGRAMS, GIVEN THE CURRENT SECURITY SITUATION. HOW MUCH ATTENTION IS THE GSL GOING TO HAVE TO DEVOTE TO DEFENSE RELATED ISSUES AND AT WHAT COST TO THE DEVELOPMENT EFFORT? DONORS SHOULD UNDERSCORE THE NEED FOR A POLITICAL SOLUTION WHICH PROVIDES ALL SRI LANKANS WITH THE OPPORTUNITY TO PARTICIPATE IN DEVELOPMENT AND RECEIVE ITS BENEFITS. THE SRI LANKAN DELEGATION SHOULD BE ASKED HOW DONOR ASSISTANCE COULD BE HELPFUL IN BRINGING ABOUT A POLITICAL SOLUTION. DONOR ASSISTANCE COULD BE USED TO RESTORE PRODUCTIVE CAPACITY IN THE TROUBLED AREAS, FOR EXAMPLE.

B. THE STATE OF THE ECONOMY SHOULD BE ANOTHER PRINCIPAL TOPIC FOR DISCUSSION. THE ANNEX TO THE POLICY DIALOGUE FRAMEWORK, RECENTLY SUBMITTED, PROVIDES DETAILS ON THE MAJOR PROBLEMS OF THE MACRO-ECONOMIC SITUATION HERE IN SRI LANKA. BASICALLY, THE ECONOMY COULD BE FACED WITH A DIFFICULT BALANCE OF PAYMENTS POSITION AGAIN BECAUSE TEA PRICES ARE DECLINING FROM THE FAVORABLE RATES IN 1984.

LOWER TEA PRICES WILL ALSO CAUSE THE BUDGET DEFICIT TO EXCEED ORIGINAL PROJECTIONS--THE FINANCE MINISTER HAS ESTIMATED AS MUCH AS RS. 2 BILLION SHORTFALL IN REVENUES FROM TEA. SUCH A DEFICIT WOULD CONTINUE THE TREND WHICH HAS WEAKENED ECONOMIC AND FINANCIAL VIABILITY THROUGH HEAVY BORROWING FROM FINANCIAL MARKETS.

B.1. THE MISSION CONCURS WITH IMF AND IBRD RECOMMENDATIONS THAT THE GSL MAKE EVEN GREATER EFFORTS TO REDUCE THE BUDGET DEFICIT--THROUGH RESTRAINTS ON EXPENDITURE AND A BETTER REVENUE EFFORT. BUDGET DEFICITS SHOULD IDEALLY BE HELD TO BETWEEN 8 TO 10 PERCENT OF GDP AND FINANCED PRIMARILY FROM CONCESSIONARY SOURCES. ON THE MONETARY SIDE, BECAUSE INTEREST RATES REMAIN HIGH DESPITE THE DECLINE IN INFLATION, MOST PRIVATE SECTOR FIRMS ARE UNABLE TO FINANCE INVESTMENT THROUGH COMMERCIAL BANK BORROWING. THEREFORE WE BELIEVE THE GSL SHOULD ADOPT A MODERATELY EXPANSIONARY MONETARY POLICY WHICH WOULD PROVIDE SUFFICIENT CREDIT FOR NEEDED INVESTMENT BUT NOT REKINDLE INFLATIONARY PRESSURES. THIS OBJECTIVE CANNOT BE ACCOMPLISHED WITHOUT IMPROVED FISCAL DISCIPLINE. HENCE, THE MISSION RECOMMENDS A RESTRICTIVE FISCAL POLICY. THESE POLICIES SHOULD BE LINKED TO A DEVALUATION OF THE RUPEE--OUR CALCULATIONS WOULD SUGGEST AROUND 25 PERCENT IS APPROPRIATE--BOTH TO IMPROVE EXPORT COMPETITIVENESS AND TO REDUCE THE DEMAND FOR IMPORTS.

C. A THIRD MAJOR TOPIC OF DISCUSSION SHOULD BE INCREASING THE PRODUCTIVE CAPACITY OF THE NON-GOVERNMENTAL SECTOR. AN IMPROVEMENT IN THE MACRO-ECONOMIC ENVIRONMENT WOULD PROVIDE A GREAT DEAL OF IMPETUS TO PRODUCTIVE INVESTMENT BY THE PRIVATE SECTOR AS WOULD THE ESTABLISHMENT OF AN INDUSTRIAL DEVELOPMENT POLICY. SUCH A POLICY SHOULD STATE CLEARLY THE GSL'S INTENTIONS REGARDING THE STATE-OWNED CORPORATIONS, WHAT PLANS ARE FOR DIVESTITURE OR CLOSURE AND WHAT ROLE THE STATE CORPORATIONS HAVE IN THE ECONOMY (WHAT ADVANTAGES OR LACK THEREOF THEY WOULD ENJOY IN COMPETITION WITH PRIVATE INVESTORS). THE MISSION WILL ENCOURAGE THE GSL TO DIVEST PUBLIC ENTERPRISES AS EXPEDITIOUSLY AS POSSIBLE. HOWEVER, IF--AS IS LIKELY--THE GSL DOES NOT CHOOSE TO DIVEST, ALTERNATIVE STEPS MUST BE TAKEN TO PUT PUBLICLY-OWNED CORPORATIONS ON A BETTER FINANCIAL FOOTING. THE POLICY SHOULD ALSO SET THE FRAMEWORK FOR FOREIGN INVESTMENT. IN THIS CONTEXT, THE U.S.

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DELEGATION COULD POINT OUT THAT IF EXISTING INVESTORS ARE EXPERIENCING PROBLEMS IN SRI LANKA, THIS WILL HAVE AN ADVERSE EFFECT ON POTENTIAL NEW INVESTMENT. IN ADDITION, THE PRIVATE SECTOR CONCERN OVER THE TAX SYSTEM WHICH BEARS HEAVILY ON PRODUCTION AND TURNOVER AS OPPOSED TO PROFITS, AND THE BURDENSOME BUREAUCRATIC PROCEDURES AND DELAYS SHOULD BE REVIEWED FOR AREAS OF IMPROVEMENT. THE MISSION WILL BE WORKING WITH PRIVATE SECTOR ORGANIZATIONS TO ENHANCE THEIR CAPABILITY TO RESEARCH AND PRESENT TO THE GOVERNMENT LOGICAL CASES FOR POLICY AND PROCEDURAL CHANGE WHICH WOULD PROMOTE INVESTMENT, PARTICULARLY IN THE EXPORT SECTOR.

D. ANOTHER AREA WE BELIEVE SHOULD BE COVERED IS THE POST-MAHAWELI NEEDS. THE MAJOR DAMS AND OTHER CONSTRUCTION WORK OF THE ACCELERATED MAHAWELI DEVELOPMENT PROGRAM (AMP) ARE NOW COMPLETED OR NEARING COMPLETION, BUT THE FOLLOW-ON WORK TO MAKE THE SETTLEMENT AREAS VIABLE, PRODUCTIVE PARTS OF THE COUNTRY REMAINS TO BE DONE. MUCH WORK STILL MUST BE UNDERTAKEN TO PROVIDE FARMERS IN THE SETTLEMENTS AN OPPORTUNITY TO RISE ABOVE SUBSISTENCE LEVELS. AN IMPORTANT ASPECT OF THIS WORK WILL BE AGRICULTURAL DIVERSIFICATION, PARTICULARLY IN THE SUBSIDIARY FIELD CROPS. ATTENTION ALSO SHOULD BE GIVEN TO DEVELOPING RURAL ENTERPRISES--ESPECIALLY AGRIBUSINESS--IN THE NEW SETTLEMENTS.

E. AT A TIME WHEN MACRO-ECONOMIC PROBLEMS DICTATE REDUCED GOVERNMENT EXPENDITURES, THE CAREFULLY PLANNED USE OF DOMESTIC AND DONOR RESOURCES WILL BE CRITICAL TO THE CONTINUED DEVELOPMENT OF THE MAHAWELI AND OTHER RURAL PARTS OF THE COUNTRY. DONOR RESOURCES, HOWEVER, CANNOT HAVE ADEQUATE IMPACT WITHOUT SUFFICIENT GSL BUDGETARY RESOURCES TO SUPPORT THEM. THE GSL SHOULD CAREFULLY LIMIT PROJECTS UNDERTAKEN TO THOSE THAT CAN BE ADEQUATELY BUDGETED FOR WITH THE RESOURCES AVAILABLE. DESPITE THE NEED FOR REDUCED EXPENDITURES AND BETTER MANAGEMENT OF RESOURCES, THE GSL BUREAUCRATIC STRUCTURE CONTINUES TO GROW. THERE ARE NOW 45 MINISTRIES AND OVER 160 AGENCIES, MOST OF WHICH HAVE OVERLAPPING RESPONSIBILITIES AND POOR COORDINATION. THE GSL MUST BE CONVINCED TO RATIONALIZE ITS GOVERNMENTAL ORGANIZATION, JOINING APPROPRIATE FUNCTIONS AND ELIMINATING UNNECESSARY ONES. THE AID GROUP MEETING SHOULD PRESENT A STRONG, JOINT INTEREST IN THE GSL DOING SO.

3. IN ADDITION, THE FOLLOWING AREAS ARE OF INTEREST TO THE MISSION:

A. COORDINATION OF AGRICULTURAL RESEARCH BASED ON A CLOSER SET OF ESTABLISHED PRIORITIES,
B. EFFECTIVE OPERATIONS AND MAINTENANCE SYSTEMS FOR THE IRRIGATION SCHEMES THROUGHOUT THE COUNTRY, AND

C. INCREASES IN THE RATE OF INTEREST AND REPAYMENT OF NATIONALLY-SUPPORTED HOUSING PROGRAM.

4. THESE POINTS OF DISCUSSION ARE PRESENTED IN MORE DETAIL IN THE POLICY DIALOGUE FRAMEWORK SUBMISSION RECENTLY COMPLETED.

5. WE ARE MEETING INFORMALLY WITH A FEW OTHER DONOR REPS ON FRIDAY, MAY 17, TO INQUIRE INFORMALLY WHAT POINTS THEY MAY BE RAISING AT PARIS MEETING AND WILL REPORT ASAP.

6. THE AMBASSADOR HAS SEEN AND APPROVED THIS MESSAGE.
REED

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UNITED STATES A. I. D. MISSION TO SRI LANKA

American Embassy
Department of State
Washington D. C. 20520

T

Mr. Eugene S. Staples
Deputy Assistant Administrator
Asia Bureau
Room 6212 NS
Washington, D.C. 20523

Dear Rocky:

Enclosed is the paper on Policy Dialogue Framework for Sri Lanka that you requested during the CDSS Review and Program Week activities. We are also responding to the request for a policy dialogue plan (STATE 088820) by incorporating the plan aspects into this paper. The paper sets the macro-economic stage and then presents the specific policy issues we plan to work on over the next several years. I believe this paper will provide the appropriate framework for our program that Allison Herrick and others were interested in at the reviews.

We are also now preparing a short cable which we will clear through the Embassy on issues for the donor group meeting in Paris. It should reach you shortly.

Cordially,

Frank

Frank D. Correl
Director

cc: John Gunning, ASIA/PNS

Attachment: as stated.

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POLICY DIALOGUE FRAME WORK FOR SRI LANKA

1. Introduction:

The major development issues facing Sri Lanka over the medium term will be reducing the public sector share of the economy and increasing the productive capacity of the non-governmental sector. As elaborated below, this Mission believes these issues will be best addressed through tightly controlled restrictive fiscal policy and moderate monetary policy at the macro-economic level. While the AID Program in Sri Lanka is in itself not sufficient incentive to bring about major restructuring of the economy, the AID Program can be a positive influence for decisions which lead to creating a more productive economy, especially when taken together with programs of the IMF, the World Bank, Asian Development Bank, and other donors.

2. Macro-Economic Policy Setting:

Given the current economic situation (reviewed in Annex) Sri Lankan policy makers are limited to three macro-economic policy options. All three require a realistic exchange rate and result from different combinations of fiscal and monetary policies. They are: (a) restrictive fiscal and monetary policy combination; (b) expansionary fiscal and restrictive monetary policy combination; and (c) restrictive fiscal and expansionary monetary policy combination.

(a) Restrictive fiscal and monetary policy combination:

From an economic management point of view, the most logical option is a restrictive fiscal and monetary policy combination. If Sri Lankan policy makers decide to pursue this option, a significant improvement in GSL budgetary discipline could be expected as public spending would be largely limited to available resources. The budget deficit as a share of GDP would not likely exceed 8% and would be financed from foreign grants and concessional loans. There would be no borrowings for budget financing and the government would gradually reduce its liabilities to the commercial banking system and the Central Bank which currently amount to over Rs.15.0 billion.

A restrictive monetary policy calls for very tight credit controls to contain money supply growth. The commercial banking system would be required to limit its lending only to productive areas as directed by the Central Bank. Bank lending would be severely curtailed to trade (both wholesale and retail), services, financing of imports and consumption. The commercial interest rate is likely to be lower because of the limited lending capacity of the commercial banking system. Under this option both savings and investment would be relatively low.

This option offers the least attraction to the GSL as it leads to a deflationary situation, particularly in the short run, accompanied by reduced economic activities and lower economic growth. Moreover, despite credit restrictions, the GSL will confront serious difficulties in controlling money supply because of the role of financial intermediaries. If financial intermediaries are not brought under Central Bank control, the economy is likely to experience lower economic growth, along with increased money supply and relatively high inflation during the medium-term.

(b) Expansionary Fiscal Policy and Restrictive Monetary Policy Combination:

This option calls for a greater government role in the economy similar to the experience

of the immediate past. In addition to focusing on continuing development projects, the government would have to undertake new development projects to maintain growth momentum in the economy and to achieve projected growth targets. Annual budgets would reflect the growing nature of public expenditure programs, and even if the revenue base is improved, there are likely to be budget deficits of substantial magnitude requiring the government to depend on extra-budgetary resources such as bank and commercial borrowings. Also, concerted efforts (as in option (a) above) would have to be made by the government to maintain a restrictive monetary policy, and reduce the rate of growth in money supply.

The fiscal and monetary policy combination that the government is currently pursuing is quite similar to this option. It offers relatively high growth prospects in the short run. However, with growing budget deficits, (exceeding 20% as a ratio to GDP), economic management will be extremely difficult. Moreover, maintaining a restrictive monetary policy will be even more difficult with an expansionary fiscal policy because of high public spending supported by borrowings. These developments will, in turn, exert strong pressures on the balance of payments. Continued reliance on external borrowings, in addition to the use of external reserves, would be inevitable. In the medium-term, economic growth would be slowed down and inflation would remain high. Within a short period the government would have to consider seriously the implementation of option (a).

(c) Restrictive Fiscal and Expansionary Monetary Policy Combination

The most promising growth outlook, particularly in the medium-term, is embodied in a combination of a restrictive fiscal and a moderately expansionary monetary policy. Under this option, the focus of public spending would be on (a) the completion of ongoing development projects, (b) improvement of physical, economic and social infrastructure, and (c) maintenance of physical and economic assets. The level of spending would be determined largely by the flow of financial resources available to the government from domestic revenue as well as external concessional sources. The budget deficit, which would be expected to remain around 8% to 10% of GDP, would be entirely financed from concessional external support. In addition, efforts would be made to contain the rapid growth in recurrent expenditure by better management of existing assets and resources of the public sector. The government would also adopt very tight financial regulations with regard to public sector corporations and undertake divestiture of non-profitable businesses as expeditiously as possible.

This option allows the monetary policy to be moderately expansionary. The main purpose of pursuing an expansionary policy would be to allow the private sector to get actively involved in growth promotion through credit facilities from the banking system. Because of the restrictive fiscal policy, the pressure from the public sector on the banking system is either minimized or totally eliminated, and this allows the banking system to provide necessary capital to the private sector for activities related to higher domestic production and export promotion. Although money supply is likely to go up, it can be more easily controlled and kept within desired targets. The annual increase of the rate of inflation would be likely to remain around 10% to 12%.

Under this option, economic growth in the short run would be expected to be somewhat lower than the 5% to 5.5% presently projected by the GSI, because of the reduced government role in the economy in terms of public spending. The main focus of public spending would be on improving the existing economic resource base and improving productivity. These efforts together with the active role of the private sector should lead to a high growth path in the medium-term along with reduced pressure on the balance of payments, relatively low inflation and higher levels of both savings and

investment.

As noted earlier, all three policy options require a realistic exchange rate policy. A realistic exchange rate simply means the selection of an exchange rate which could bring down the deficit in the current account of the balance of payments to match normal capital flows such as private foreign investments and foreign grants and concessionary disbursements but excluding commercial borrowings either medium or short term. When defined in this context, the selected exchange rate should result in higher export earnings, reduced imports or both. A floating exchange rate approach is perhaps the ideal system to establish a realistic rate as the imperfections in exchange rates are eliminated through market mechanisms. However, a floating exchange rate is the least popular policy in most developing countries because of its direct and unpredictable consequences on domestic prices. The price adjustments associated with a floating exchange rate system are difficult to control since movements in exchange rates are directly reflected in the prices on imported consumer, intermediate and investment goods.

Avoiding a floating system leaves the foreign exchange rate adjustment to be implemented through a devaluation. The amount of devaluation necessary to bring the exchange rate to realistic levels is difficult to determine, given the complex factors involved in the determination. Most economists who support a devaluation under present circumstances in Sri Lanka tend to believe that a rupee devaluation in the magnitude of 25% against the U.S. dollar should eliminate almost all the distortions currently prevailing in the foreign exchange market.

Whatever the options that Sri Lanka selects of the three mentioned, there will be some economic and social costs. The Mission believes the third option to be the most appropriate in the present context despite its slower growth prospects in the short run. The fiscal and monetary policy combination proposed in option (c) would lead to a stable economy and much improved growth performance during the medium-term. In either the absence of adjustment policies or the selection of inappropriate policies such as option (a), current problems are likely to be intensified in the medium-term, and more difficult and painful adjustment policies would be required later to bring some stability to the economy. It is this restrictive fiscal and moderately expansionary monetary policy which USAID will advocate in our macro-economic policy dialogue. In this effort we expect to be working with the IMF, World Bank and other bilateral donors.

3. Policy Dialogue Plan:

The tighter fiscal policy of option (c) will require that the GSL bring down the budget deficit substantially. While enhanced revenue generation would contribute to reducing the budget deficit, the Mission would argue against revenue increases likely to dampen private investment initiatives. Thus, even with moderate revenue increases, further reductions in the operational accounts will be necessary and capital programs will have to be eliminated or delayed. Without the expansionary fiscal policies that have been followed over the past eight years, it will be difficult to maintain, over the near-term, the 5% to 5.5% growth rates projected by the government. However, stabilizing the economy should allow for improvements in private sector confidence and export competitiveness accompanied by a return to respectable growth rates in the medium-term.

The set of macro-economic policies recommended by the Mission (and other donors) for achieving stable growth over the rest of this decade will require that more be done with existing resources. These policies set the framework within which the USAID strategy

will provide direct support to the development effort. The major policy issues that will occupy the attention of the Mission over the next three to five years are:

- A rationalization of the GSL bureaucratic structure.
- Selective reversion of state-run enterprises to the private sector.
- Establishment of an industrial development policy which provides clear guidelines for private sector involvement.
- Establishment of an agricultural diversification strategy (within the overall Agriculture, Food and Nutrition Strategy) which reduces the bias for rice among GSL support services.
- Coordination of agricultural research based on a clear set of established priorities.
- Reform of agricultural pricing and subsidies policies to allow for a more open and market regulated commerce in agricultural inputs and outputs.
- Reform of the land tenure system to efficiently legalize land holdings and to provide for holdings of adequate size to be commercially viable.
- Development of the private sector through adoption of measures to facilitate private investment and assure competitiveness.
- Commitment to operations and maintenance programs for irrigation schemes throughout the country including the participation and support of water users and the collection of user fees.
- Increases in the rates of interest and repayment for nationally-supported housing programs.
- Integration of planning into decision making for the program areas in which USAID is operating.
- Commitment by the Ministry of Health to the need for preventive health programs rather than curative facilities.
- Improvement in the conditions for private sector credit, especially in the rural areas.
- Incentives for management improvement.

One of the Mission's principal policy objectives is a rationalization of the GSL's bureaucratic structure. There are presently 45 Ministries, over 160 autonomous agencies and untold numbers of committees, councils and other such bodies. The functions and responsibilities of these organizations overlap severely yet little, if any, coordination takes place. The Mission, therefore, will be recommending that an appropriate way to reduce the budget deficit through reduced expenditures will be the elimination of bureaucracies duplicating functions and responsibilities best carried out in another government organization. The World Bank is now developing a project to be directed at improving management and efficiency within the government. We will add our voice to theirs at the policy level to help bring about needed changes. In addition, bureaucratic reforms will be pursued within the organizations directly affected by our project activity. For example, the effort to develop a planning and financial management capability within the Mahaweli Authority of Sri Lanka (MASL) will allow the Mission to argue for organizational changes both within and outside the MASL where overlapping or unnecessary functions can be eliminated.

The need to return publicly run enterprises, both agricultural and industrial, to private ownership has long been recognized as a policy issue. The AID program in Sri Lanka has not been sufficiently large for AID to take on this issue directly. That remains the case today. Donors have raised the question of de-nationalization on government-held estates. The GSL remains unwilling to do that in any significant way, and the private sector seems unwilling to re-enter the field in view of massive investments needed and fear of subsequent renationalization. In any case, with the World Bank and the ADB providing

substantial assistance to rehabilitate the estate sector, there seems little opportunity to pursue this issue further.

The Mission will continue to support divestiture of the publicly owned corporations such as those in steel, cement, paper products, building materials, hardware, and telecommunications to name but a few. In some cases, such as telecommunications, the dialogue within the GSL has begun. We would also argue for the closure of loss making corporations if there is no private sector interest in a takeover. Realistically we cannot expect the AID program to provide sufficient leverage to put these industries into private hands, but we can use the program to support the case. Through the Sri Lanka Business Development Center (SLBDC), as one means, the government can be presented with a series of well supported arguments to show that decisions to divest should be made sooner rather than later. This case can be based on the need to reduce the budget deficit and the strain placed on the budget by the continuing losses incurred by the state-run corporations and, equally important, the prospects for profitable operations with ownership in private hands. The USAID will use appropriate opportunities to bring this argument before high-level government officials, but our most effective means to deal with this policy issue will be in strengthening institutions, such as the SLBDC, representing the private sector in the policy dialogue with the government.

Since state-owned enterprises still generate over half of industrial output and dominate several industrial sectors, there is a lingering and often very real antagonism between powerful vested interests in the government, on one hand, and the private sector interests on the other, regarding the role which each should play in a given industry. This antagonism creates enough doubts about government intentions (or its ability to resist vested interests) for prudent private investors to be cautious when contemplating investments which may become vulnerable to government decisions to protect or otherwise favor competing state enterprises.

The fundamental issue can be reduced to the GSL's intentions (and actions) on "privatization" of state-owned corporations. Several studies by USAID (1983 A.D. Little private sector assessment), UNDP, and the World Bank have addressed the advantages to be gained through various privatization moves, ranging from outright divestiture (favored by the Mission) to retention of state corporations, but on a truly equal competitive footing with the private sector. To date there has been much verbal commitment to act on recommendations made in these studies, and a special GSL-appointed Committee on Public Enterprises (COPE) has been established to guide the government's decisions. However, no state corporation has yet been disposed of by the government. The most concrete actions which have been taken are several management contracts (most notably for the state textile mills) under which foreign private managers have been brought in to turn around ailing state enterprises, or instances in which a previously state-monopolized sector (e.g., bus transport) has been opened up to private sector competition.

In this environment it is essential that the government decide upon and convincingly implement, through visible actions, an overall privatization plan for continued operation of state-owned enterprises and the advantages (ideally none) which they are to have in competing with the private sector. At a minimum, the private sector community must become convinced that vested interests committed to protecting the state's role can be contained, that new state enterprises are unlikely to start up, and that a future wave of nationalization will not occur.

Since mid-1984, the government has formally recognized the need for a national industrial development policy and has brought into being a high-level joint

government-private sector Industrial Policy Committee to work toward the establishment and implementation of such a policy. The Committee as a whole, and in particular the private sector leadership on this Committee, can and should be supported by USAID in reaching its objectives. Ultimately, what is needed is three-fold: (1) a well-articulated overall industrial development policy providing a framework to guide and encourage investment decisions; (2) sector-by-sector, and subsector-by-subsector, industrial development strategies which spell out in very specific terms the future roles for both the private and state sectors, including any specific guidance for foreign investment; and (3) implementation of the program with primary attention to concrete privatization action where such action is called for. Such a policy statement will be a primary objective of our private sector program.

In agriculture sectoral policy, there is currently a clear public bias towards rice, in terms of interest, resource allocation and infrastructure development relative to other field crops. This bias is understandable given the importance of rice to both consumers and producers. Rice self-sufficiency has been the GSL's number one agricultural sector goal and is now within reach. Further extension of the rice production margin at this point, however, would not be an optimal allocation of resources. While continued investment in rice research, production and marketing is clearly needed, it also is necessary for the GSL to adopt and support a clear strategy of rational agricultural diversification.

Apart from the lack of an overall strategy, there are no significant policies adversely affecting agricultural diversification. The quantity and timing of imports have been a problem but are not a policy issue. This problem can be handled through better market intelligence, forward planning and more timely action, all of which should result from a comprehensive agricultural diversification plan. There are no effective product subsidies relative to the subsidiary field crops (SFC); prices are determined by the market and the impact of the two major input subsidies (fertilizer and irrigation water) is negligible, since most SFC are produced without chemical fertilizers under rain fed conditions. Seed is another subsidized input discussed below. Diversification is dependent on increased investment (public and private) in research and market development and a commitment on the part of the GSL to support rational alternatives rather than continue to push rice production beyond the boundaries of economic rationality (at the likely cost of renewed producer and/or consumer subsidies and price controls). In conjunction with our efforts in diversified agricultural research (363-0058) and agricultural policy and planning (383-0083), the Mission will attempt to get a rational agricultural diversification strategy/policy statement.

Production and marketing of improved field crop seed is now entirely in the hands of the Department of Agriculture. Costs to farmers are subsidized. As long as quality seed cannot be sold at a price reflective of its true costs of production, significant private sector investment in the seed industry is unlikely. A change in GSL policy toward more rational seed pricing appears warranted, from the perspective of both more realistic resource allocation and promotion of private investment. The Department of Agriculture is in accord with this view; the problem lies in the political realm. USAID and the Netherlands are currently involved in the seed production/marketing area (USAID, through the Diversified Agriculture Research Project) and are working together to promote a more realistic seed pricing and production policy on the part of the GSL.

A large number of institutions are engaged in agricultural research in Sri Lanka. Consequently, it is highly fragmented, and the minute sub-division of research has led to problems of poor planning and resource management at the national level. Resources for agricultural research are not allocated on the basis of clearly defined research

priorities, as there is no mechanism to do so. Another serious concern is the lack of inter-institutional coordination of research; though farming system research (which involves more than one agency) is widely discussed, there is no evidence of it being practiced anywhere in the country. Maximizing farm income through the optimal use of land and water resources clearly requires improved coordination of agricultural research activities.

The Mission has initiated a project on Diversified Agricultural Research (383-0058) which will provide for improvement in the technical aspects of agriculture research carried out within the Department of Agriculture (DOA). An integral part of that project is the dialogue leading to improved coordination and the setting of research priorities for the institutions within the DOA. Through that project and the PL480 Title I/III program, we also will be encouraging better coordination among the DOA and institutions outside the DOA. The NAFNS recommended the establishment of a Council for Agricultural Research Policy to advise the GSL on research priorities and the promotion of inter-institutional research projects. The Mission will support the development of this council if it is to be given real authority and actively carries out the intended role.

With market forces determining the prices of agricultural outputs and inputs, the agricultural pricing policy of the GSL continues to remain largely inconsistent with its open economic policies. The government's role in agricultural pricing is essentially limited to setting floor prices in rice and 14 subsidiary crops. It also determines the prices for sugar and wheat on a "No-profit, No-loss" basis. All other agricultural prices are determined by market forces. The government occasionally intervenes in the domestic rice market, through buffer stock operations, to stabilize prices. Among agricultural inputs, the fertilizer price is to some extent influenced by the government's subsidy, but its role is gradually diminishing as the fertilizer subsidy has been fixed at Rs 1.0 billion in current prices since 1981. The government plays no role in setting prices of other farm inputs and wages, and its role in rural credit through state owned banks is also declining due to a high incidence of default. An increasing share of rural credit is being provided to the farmers by private lenders but at much higher interest rates.

The macro-economic environment which has prevailed since about 1980 has produced considerable distortions in agricultural pricing. While rapid inflation resulted in a manifold increase in production costs, the overvalued exchange rate caused the domestic prices of agricultural goods to remain low or to stagnate because of substitution from under-valued food imports such as wheat. The growing disparity in production costs and prices of farm produce is being reflected in the deterioration of profit margins in farm production. This situation warrants serious consideration as it could become a major constraint to the promotion of food production. Inadequate and imperfect marketing information is another issue hindering agricultural production and particularly crop diversification. This shortcoming often leads to over production in some crops and shortages in others.

As the agricultural pricing policy functions within a macro-economic environment, an improvement in macro-economic management, through an appropriate mix of fiscal, monetary and exchange rate policies, should be the major focus at the present time. The macro policy mix should place priority on relatively low inflation and elimination of exchange rate distortions, and macro-economic option (c) recommended by the Mission is in conformity with these objectives. These changes are likely to push agricultural prices up by about 20%. To help protect the low income household from rising prices, early implementation of the proposed revisions to the food stamp scheme is important. A

gradual removal of the fertilizer subsidy is another important step that should be taken by the government and should be implemented within an appropriate macro policy setting, as in option (c), to reduce the adversities of subsidy removal on production costs and prices. These issues are being discussed with the GSL in the context of the PL 480 Title I/III program and the ongoing work of the National Agriculture Food and Nutrition Strategy (NAFNS). They will also be a focus of the proposed Agriculture Policy and Planning Project (383-0083) which will follow the NAFNS effort. Agricultural pricing and subsidies are also affected by other priority agricultural development needs on which the USAID will be working, and the Mission strongly feels that the GSL should place its investment priority in agriculture on (a) agricultural research, including crop diversification, (b) improvements in marketing and extension net works, and (c) better water management.

Land tenure is particularly important to increasing the small farmer's productivity - especially in field and minor export crops - as he will be less willing to undertake innovations and, in most cases, incur the debt necessary to be innovative without secure title to his land. GSL policy supports the "regularization" of tenure on public lands, but bureaucratic practice lags far behind. Improvements in the process of land titling must be made together with a policy decision to grant clear title. The land tenure issue will be a primary concern of the entire agriculture and rural development program and will also be addressed by the PL 480 Title I/III program.

Farm size and structure are a critical issue, particularly with the large-scale settlements currently being implemented in the Mahaweli area. In the settlements each farmer is being allotted 2 1/2 acres of lowland and a half acre of highland (homestead), regardless of his location in the soil catena. This policy ignores soil type and hydrology and the productive capability of the land. Some farmers may benefit substantially while others can do little better than subsistence farming. Consequently, the settlement policy needs to be carefully assessed in terms of its likely impact on the quality of income. The question of scale of settlement is pivotal to creating commercial-vs-subsistence agriculture. In the System B area of the Mahaweli, which is still in the pre-settlement stage, AID is in a position to address it directly. Priority will be given to assessing the income potential of different soil types and sand classes and to identifying viable options and alternatives for settlement. Through ongoing Mahaweli development programs the USAID will carry on the dialogue to demonstrate to the GSL that given the wide range of soil types and agroclimatic conditions over different areas of the country, the policy of implementing a standardized unit of settlement across the board is not the best policy. The new Mahaweli Agriculture and Rural Development Project (383-0086) will incorporate the findings of the land size studies.

The government appears to be committed to more direct private sector participation in national-level planning, but how this commitment can evolve institutionally will depend mainly on the private sector's own organizational initiatives. At present the private sector is too fragmented in its organization to be as strong a voice as it could be in influencing government policy. There are five or six principal chambers and also a Federation of Chambers of Commerce and Industry. While each has articulate spokesmen who have been able to project its membership's particular views to the government on issues of the moment, there is no single organization that has constantly, comprehensively and successfully represented the private sector's position on the overriding policy issues affecting national development.

what is needed ultimately was expressed in the 1983 A.D. Little study as a private sector "National Economic Development Advisory Council" (NEDAC), which would be recognized by the President, represent a true cross-section of private business organizations and interests across the country, and be supported by a competent full-time secretariat. The secretariat would conduct studies, prepare reports, arrange for dialogue on key issues, provide inputs to national economic development strategies, and help implement the NEDAC's agenda. One opportunity to move toward the establishment of a group like the proposed NEDAC, and which is now receiving USAID support, is the newly-incorporated Sri Lanka Business Development Center (SLBDC). The SLBDC has a Business and Economic Policy Division which is geared to undertake policy studies for the private sector under the guidance of an advisory group consisting of representatives of the principal private sector chambers and other business leaders. This advisory group, (whose work is only just beginning) could, if well managed, evolve into a more formally constituted organization, i.e., an "NEDAC", with the SLBDC providing the secretariat until such time as the organization spun off completely and had a secretariat of its own.

This opportunity will be pursued during the next several years, while at the same time other approaches to coordinating or organizing the private sector for better articulation on policy issues will be investigated.

A much larger concern regarding the role of the private sector and its productive participation in the economy arises from economic factors. Frequently voiced issues by the private sector include: (a) high market interest rates, (b) burdensome administrative procedures and delays in obtaining relatively low cost medium-term funds made available by the world bank through the domestic banking system, (c) high rate of inflation, (d) unfair import competition due to either over-valued exchange rate or lower import tariff, and (e) high rate of domestic taxation, particularly, the business Turnover Tax (BTT), which must be paid even under the circumstances of production losses. Despite efforts to promote the private sector to assume a greater role in the economy, the success is bound to be severely limited if due consideration is not given to these issues. Moreover, business confidence on the economy and government policies is likely to deteriorate if measures are not taken to deal with these issues and constraints. In our opinion, the solution, to a greater extent, lies with an appropriate macro policy mix.

The GSL policy of providing free or nearly free water to the farmer for agricultural production is the largest subsidy in the agricultural sector. Over 40% of the GSL public investment budget goes to the agricultural sector. Over 60% of the agricultural budget goes to support irrigated agriculture, most of which is for construction, operation and maintenance of irrigation systems. Since so much of the agricultural budget goes toward providing free or nearly free water to the farmer, development of a system of cost recovery to pay for irrigated agriculture on a sustaining basis is an urgent priority which the Government acknowledges. The Mission's efforts in this regard have been substantial and some progress is being made.

Two policy issues which represent major constraints; (1) the inability of the present irrigation system to provide the correct amount of water to the right place when needed at minimum cost; and (2) no system for providing the required funds to properly manage, operate and maintain the irrigation systems. In the first, the need is to establish clearly a system of operations and maintenance that will keep the irrigation systems operating at efficient and effective levels. Technical assistance is now being provided to the GSL in the first

stages of developing such a policy. A commitment to follow through on the policy will be critical to continuing U.S. assistance in this area.

Another policy concern is the participation of the water users, principally small farmers, in managing the systems. Under the ongoing Water Management project (383-0057), water user associations have been formed and found to be a successful way to involve the farmer in decisions on water use. The continuation of this program has run into problems which may reflect a lack of full commitment by the GSL. The collection of water user fees to recover the costs of operating and maintaining the irrigation systems is linked with the user associations. The GSL has initiated fees for irrigation water; while there are still bureaucratic mechanisms to be worked out, that major policy decision has been made. However, the water user associations are important in educating farmers on why the fee is needed and allowing them a voice in how it is spent. The Mission remains convinced that water user associations are important if the irrigation systems are to operate efficiently. Therefore, a GSL commitment to institutionalize the program fully will be a condition to future projects in water management.

While subsidies are a feature of many of Sri Lanka's public sector programs, the Mission has paid particular attention to the problems of the shelter sector and has worked with the GSL to identify and gradually minimize existing subsidies. Shelter sector subsidies tend to be located either in building prices (which do not reflect actual cost), interest rates levied (which may range from zero upwards) or lack of commitment to collect amounts due or to take punitive action for non-performance.

When AID entered the shelter sector in 1960, it began a series of negotiations with the GSL to identify major issues. As a result of these discussions and AID's production of a Shelter Sector Assessment, four topics were chosen for further study: finance, subsidies, housing needs, and management. Of these, housing subsidy was found to be the key element, and a principal objective of the subsequent \$100 million Sri Lanka Housing Guarantee program was deemed to be progress on reducing the extent of subsidy. AID embarked on a technical assistance and training effort with the GSL to remedy some of the outstanding problems: building standards and types were radically changed so that the actual costs were affordable. Programs were developed to introduce the private sector as the "turnkey" builder. Through a process of strenuous negotiation and incremental implementation, interest rates were levied on public housing units and raised from 3% to 6% to 9% and at present to 10% on certain types of loans. Finally, an innovative and vigorous collections effort was mounted using techniques and technologies transferred from the United States. Although much work remains to be done, selected districts in Sri Lanka are achieving rates of over 80% collections for housing programs in which USAID was involved - a significant performance for this type of program. The Mission will continue to seek a raise in interest rates toward real market rates, currently in the 16 to 22% range, and acceptable (over 90%) collection rates for all national programs. Interest and collection rates in these magnitudes will allow the private sector to re-enter the housing market.

Recently, with AID support, the GSL has prepared a National Agriculture Food and Nutrition Strategy (NAFNS), but despite the NAFNS effort, planning throughout the GSL is still perceived as project preparation, often in response to donor initiatives. Priority is given to developing new ideas into projects rather than careful management of limited resources. Planning is little used by senior officials in deciding policy and operational objectives. The reason

may be the "chicken and egg" predicament. Is planning weak because it has no role in decision-making or does planning have no role because of weak technical skills?

The Mission plans to build upon the NAFNS to foster institutionalization of the planning and policy formulation capacity within the relevant agriculture and rural development organizations. We will work to convince policy makers of the need for good planning, and the use of planning in the decision-making process will be a specific objective of our work in agriculture policy and planning, and in the further programs in the Mahaweli region.

Improvement in the availability of credit, particularly in the rural areas, will be a crucial factor for the development efforts to be undertaken through the rest of this decade. Credit will be needed to make effective use of the available land, water and labor resources in agriculture, as well as to increase investment in rural enterprises. Currently almost all rural credit schemes are developed at the national level with no design input from the local level. Hence, programs are often ill-suited for areas they are intended to serve.

The USAID, through programs in agricultural planning and rural enterprises, will encourage the development of credit plans specifically geared to the region/district targetted. These plans should identify and assess the credit needs of the area and propose suitable arrangements to finance those needs. Further study will be supported and appropriate policies will be proposed through those studies.

The improvement in the macro-economic climate is also an influencing factor on the availability of rural credit. Reducing the GSL budget deficit and its borrowings in the domestic credit market coupled with mildly expanding money supply should allow for greater availability of credit at reasonable cost. Together with private investors, the confidence of bankers and other financial intermediaries should increase with economic stabilization, thus loosening credit bounds.

In the health area the Mission policy will be to encourage the Ministry to introduce the internal, administrative reforms that will permit a more effective use of manpower and financial resources, to encourage the government to put health programs on a self-financing basis, and to support the government's policy of improving the preventive health care system. While donor assistance can be helpful in identifying problems and recommending policy changes, only the Ministry can carry out the basic reforms which are needed. The Mission, therefore, will continue to make limited technical assistance available to help the Ministry address critical problems; however, with the anticipated budget stringency in world wide U.S. development programs and the slim prospects of early payoff in the field of administrative improvements in the Health Ministry, this is not likely to be an area of major effort for the Mission in the future.

A universally recognized constraint to development in Sri Lanka is poor management, and the resolution lies in provision of performance incentives for better management. The NAFNS identified four factors responsible for poor public sector management: 1) past policies of public sector employment practices, 2) low salaries in the public sector, 3) limited training opportunities, and 4) few incentives to improve the caliber of management. The AID program can do little about the "spoils" system of the past, and we are

unlikely to have any influence in raising salaries, particularly in light of the need to hold down public expenditures. The World Bank project on administrative reform is expected to deal with these issues, and the Mission would support improvements in these areas. We can, however, have some direct impact in the area of training. We are insisting now that training be clearly related to improving management or technical capabilities in specific fields relative to our program and that training under our sponsorship be part of an established plan and set of priorities of the GSL. On the fourth point, the Mission will be attempting to build in non-monetary management incentives to project activity to stimulate an interest in improving management practices. Such incentives could include increased authority/status, training opportunities, access to technology and others to be developed under the Development Training and Support project (383-0085).

ANNEX
MACRO-ECONOMY REVIEW

The Sri Lankan economy has shown respectable progress since the implementation of economic and trade liberalization policies in 1977. This progress is evidenced in the growth in Gross Domestic Production (GDP). Real GDP growth averaged 6.8% per annum between 1978 and 1980 and 5.3% between 1981 and 1983. In 1984, real GDP growth has been tentatively estimated at 5%. An annual GDP growth rate of between 5% to 5.5% in real terms remains the government's growth target for the future, particularly during the medium-term.

Maintaining growth around this projected magnitude is crucially important to Sri Lanka to address its development needs. A growing economy is also important to carry out liberalized economic and trade policies without having to introduce quantitative restrictions and trade and exchange rate controls as in the period before 1977. However, the ability of the government to maintain the projected growth on a sustainable basis appears to be less promising in the present context of Sri Lanka's economic conditions. The economy has already begun to show considerable strains of excessive demand pressures, accompanied by over ambitious development programs, and a less conducive external environment which emerged after the 1979 oil price hike.

In 1984, higher tea prices produced exceptional circumstances which lead to higher growth performance than would have been possible under normal conditions. Higher tea prices helped both the balance of payments and budgetary receipts, the two major problem confronting the Sri Lankan economy during the last few years. However, as price movements in international commodity markets have repeatedly shown a high degree of volatility, higher tea prices are likely to be, more-or-less, a temporary feature. Given this uncertainty in international commodity markets and the current difficult economic situation, the government will have to be seriously concerned with its economic and development policies to bring them in line with the potential capacity of the economy. Essentially, such realignment calls for corrective fiscal, monetary and exchange rate policies to promote economic stabilization. If such measures are not taken or delayed too long, the Sri Lankan economy will experience further deterioration in its economic situation which will in turn result in a less favorable growth outlook during the medium-term.

The discussion that follows (Section 2) briefly reviews the magnitude of the budgetary and balance of payments problems with specific reference to the period after 1980. In the third section, their implications on the economy will be discussed as reflected in (a) savings and investment imbalance, (b) inflation and (c) public debt.

2. Brief Review of Economic Issues:

Sri Lanka's current economic problems are very closely linked to its continuing deficits in both the budget and the current account of the balance of payments. These problems emerged in the early 1980's partly due to the government's continued reliance on expansionary financing for its over ambitious development programs and partly due to a combination of events which caused the international economic environment to be less favorable. The latter includes substantial fluctuations in world commodity prices, sharp increases in the cost of energy products and capital goods, reduced growth performance in major industrial countries and high market interest rates. The most devastating effect of the adverse external factors on Sri Lanka's economy has

been observed in its sharply deteriorating terms of trade.

In spite of the emerging difficult economic situation in Sri Lanka, the government remained firmly committed to promoting growth in the economy, and the developments that followed clearly reflected the consequences of the government's priorities on economic growth. Moreover, most of the consumer subsidies which were prevailing in the Sri Lankan economy for many years had been removed by the early 1980's in order to divert domestic resources away from consumption and into development. This diversion led to the expectation of faster economic growth and much improved socio-economic living standards to the Sri Lankan population.

a) Public Spending and Budget Deficits :

Table I summarizes the government's budgetary operations over the 1978-85 period. A number of points are clearly apparent in the figures presented in this table: (a) public spending has been growing at an unprecedented rate; (b) budgetary receipts persistently lag behind budgetary expenditures; (c) budget deficits have remained unmanageably large; and (d) financing of budget deficits required borrowings from both domestic and external sources.

In aggregate terms, total public spending (current and capital) of both actual and planned over the 1978-85 period amounted to Rs.298.5 billion in current prices, while revenue during the same period totalled Rs.170.6 billion, accounting for only about 55% in terms of total expenditure. This difference resulted in an accumulated budget deficit of Rs.109 billion equal to 45% of the expenditure total. In both 1980 and 1982, budget deficits remained higher than government revenue.

In financing the massive budget deficits, external assistance, including both concessionary and non-concessionary sources, remained a principal support accounting for 65% of the total deficits and indicating the extent to which domestic expenditure outlays are dependent upon foreign financing. Borrowings from non-banking sources, i.e., trust funds, provident funds, and savings institutions, have assumed second importance while the borrowing from the domestic banking system supported Rs.17.0 billion (16% of the budget deficit in aggregate terms).

There have been some efforts by the government to improve budgetary and fiscal discipline and to strengthen economic and financial viability. Spending cuts were imposed in the 1981 and 1983 approved budgets (10% and 20% respectively). In 1981, a cabinet decision was taken not to introduce new projects either by the government or by the public sector corporations. The emphasis was placed on the successful completion of on-going projects. The Ministry of Finance and Planning also issued directions to all public sector corporations to improve their financial viability without depending on the Treasury for budgetary support. In addition, almost all consecutive budgets since 1980 have resulted in higher taxes from indirect sources.

Despite these efforts, the budgetary discipline improved only marginally reflecting the continuing presence of massive financial imbalances. The reason for the poor performance stems from the government's failure to strictly enforce the proposed measures. Although the "no new development projects" decision was understood to be a general rule applicable to all new projects, the cabinet from time to time approved new development projects, thus deviating from the rule laid down by the government itself. In addition, the Ministry of

Table 1

SUMMARY OF BUDGETARY OPERATIONS (1978-1985)

	1978	1979	1980	1981	1982	1983 <u>b/</u>	1984 <u>c/</u>	1985 <u>d/</u>	TOTAL 1979-1985
1. Revenue, Expenditure and Financing (Rs.Mn.):									
Revenue									
Current Expenditure <u>a/</u>	11,688	12,730	14,068	16,228	17,809	25,210	34,588	38,041	170,362
Capital Expenditure	12,239	12,531	16,489	17,721	19,231	25,083	28,217	29,764	161,275
Budget Deficit	6,614	8,991	13,854	13,373	18,669	23,131	23,160	29,734	137,526
	7,165	8,791	16,274	14,866	20,091	21,606	16,789	21,457	108,957
Financed by :									
a) Foreign Grants and Loans	4,454	4,237	6,735	8,208	8,794	10,950	13,068	14,071	70,517
b) Domestic Non-Market Borrowings	453	1,096	- 216	400	1,713	2,385	-	-	5,831
c) Domestic Market Borrowing From Non-Bank Sources	2,085	2,806	2,700	2,379	5,984	7,797	3,721	7,386	34,858
d) Borrowings From The Banking System	115	680	7,126	3,917	3,915	1,168	-	-	16,930
e) Other (Cash Balance)	58	- 28	- 72	- 38	-315	-694	-	-	-459
									AVERAGE 1978-1985
2. Memorandum Items (As GDP Shares) :									
Revenue	28.9	25.6	22.6	20.5	19.4	22.6	27.0	25.7	24.0
Recurrent Expenditure	30.2	25.2	26.5	22.3	21.0	22.5	22.0	20.1	23.7
Capital Expenditure	16.3	18.1	22.3	16.9	20.4	20.8	18.1	20.1	19.1
Budget Deficit	17.7	17.7	26.1	18.7	21.9	19.4	13.1	14.5	18.6

a/ Includes Advance Account Operationsb/ Provisionalc/ Estimated/ Projection

Source : GSL Budgets and Central Bank of Ceylon.

Finance and Planning was compelled to accommodate requests for additional budgetary allocations, in excess of approved allocations, by various ministries, and this practice threw the budgetary discipline completely out of balance. Moreover, due to political pressure, the policy of "no financial support to public sector corporations" became practically impossible. Between 1978 and 1983, public sector corporations, excluding the Mahaweli Development Authority, were granted Rs.25.0 billion for operational losses and capital improvements.

The expansionary nature of development programs is clearly demonstrated when the major budgetary features are expressed in terms of GDP. Between 1978 and 1983, the annual expenditure total (both recurrent and capital) worked out to be between 46% to 48% of GDP. Even the 1984 and 1985 estimates show the expenditure shares to be around 40%, implying no significant improvement in budgetary discipline. In contrast, revenue as a share of GDP remained poor, particularly during the 1980-83 period, resulting in a high budget deficit share of GDP. Although the budgetary developments show some improvement since 1984, the improvements are still far from satisfactory to restore economic and financial stability.

b) Current Account Deficits in the Balance of Payments :

As shown in Table 2, Sri Lanka's balance of payments experienced strong destabilising pressures under economic and trade liberalization and particularly during the period between 1980 and 1983, when the world economic environment turned less favorable. The current account deficit as a ratio to GDP sharply increased from 12% in 1979 to 21% in 1980, slightly moderated between 1980 and 1983, (due to reduced expenditure on imports and increased private remittances) and declined sharply to around 5% in 1984. As noted earlier, higher tea export earnings were the principal reason for this marked improvement.

The recent developments in the balance of payments reflect the effects of two important factors: (a) deterioration in the terms of trade and (b) domestic demand pressures. The terms of trade have progressively declined since 1976 but turned increasingly unfavorable after the 1979 surge in energy prices. On the other hand, increased public spending stimulated domestic demand which together with expansionary means of deficit financing intensified the pressure on balance of payments. In addition, historically high interest rates in world financial markets, declining foreign aid on concessional terms, and global economic recession further compounded the balance of payments difficulties.

Although adjustment policies to ease the mounting pressure on the balance of payments, became crucially important to the Sri Lankan economy, the government response remained poor. As a result, the measures taken proved grossly inadequate. Exchange rate adjustment was the main instrument that the government employed to correct the situation. The rupee experienced progressive depreciation, particularly against the U.S. dollar, but the rate of depreciation was monitored and supervised by the Central Bank. As a result the rupee was kept artificially over-valued against all the leading international currencies. In the case of leading European currencies such as Sterling, the Deutsch Mark and the French Franc, the Sri Lankan rupee in fact strengthened, reflecting serious distortions and rigidities in exchange rate policies.

The over valued exchange rates considerably increased the severity of the balance of payments problem due to reduced export competitiveness in both

BALANCE OF PAYMENTS AND FINANCING
OF THE EXTERNAL RESOURCE GAP
(RS. MILLION)

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Trade Balance :	-7,288	-16,312	-15,616	-20,403	-20,168	-10,365
Exports	15,282	17,603	20,507	21,098	25,038	37,347
Imports	-22,570	33,915	36,123	41,501	45,206	47,712
Services (net)	740	859	82	- 314	-1,911	- 1,556
Private Transfers (net)	753	2,260	3,918	5,494	6,441	7,039
Current Account Balance :	-5,795	-13,193	-11,616	-15,223	-15,638	- 4,884
Capital Repayments <u>a/</u>	-1,760	- 5,193	-13,766	-14,075	-17,012	-15,519
Total Resource Gap	-7,555	-18,386	-25,382	-29,298	-33,450	-20,403
Finance :						
Grants	2,239	2,281	3,118	3,379	4,016	3,903
Direct Investment	769	753	1,003	1,377	929	912
Concessionary Aid <u>b/</u>	2,903	4,143	5,350	5,967	7,330	10,075
Non-Concessionary <u>c/</u>	3,819	6,963	17,966	20,685	21,620	12,099
Short-term	(609)	(4,455)	(10,966)	(10,504)	(14,370)	N/A
Suppliers Credit	(41)	(441)	(489)	(3,396)	(871)	N/A
IMF	(1,834)	(630)	(4,528)	(1,506)	(1,622)	N/A
Other <u>d/</u>	-	1,360	401	- 119	848	- 671
External Assets	-2,175	+2,886	-2,456	-2,011	-1,293	-5,915
(- = Increase)						
As a % of GDP :						
a) Trade Balance	14.6	26.2	19.7	22.2	18.5	-
b) Current Account Deficit	11.6	21.2	14.6	16.6	14.4	-
Exchange Rate	15.5	18.0	20.5	21.3	23.6	25.3

a/ Include repayments on long-term loans, short-term loans, suppliers credit.

b/ Include project Aid, Commodity Aid, Food Aid, IMF Trust Fund.

c/ Include short-term Credits and borrowings under the IMF stand by agreements.

d/ Include SDR allocation, valuation adjustments and errors and omissions.

Source : Central Bank of Ceylon

traditional and non-traditional export goods. This reduced export competitiveness occurred while the demand for imports continued to increase significantly based on high domestic demand and increased money supply. Domestic credit rapidly increased from Rs.25.8 billion in 1980 to Rs.49.3 billion in 1983, and this credit expansion has been an important contributor to higher expenditure on imports.

3. Implications of Structural Imbalances :

a) Investment and Savings :

Since 1978, the Sri Lankan economy experienced impressive growth in capital formation. Between 1979 and 1983, gross capital formation as a share of GDP increased from 27% to 32%. Before 1977, this ratio often remained less than 20%, and in this context, the recent experience indicates notable improvements in capital formation. However, capital formation only reflects the amount of investment that has taken place in the economy but does not show how this investment was made possible. To understand the characteristics of capital formation, therefore, the savings investment behavior must be examined.

Table 3 illustrates investment and savings trends during the 1978-83 period. Although investment as a share of GDP remained appreciably high during the period, the savings record reflects an extremely poor performance and indicates an extensive gap between savings and investment. Moreover, although public sector investment remained consistently positive, accounting for more than 50% of annual investments, the public sector savings balance remained negative. Appreciable growth in public sector investments did not come from its own savings.

The trends in investment and savings lead to two important observations. First, capital formation has been supported to a great extent by both domestic and external borrowings. Secondly, a considerable share of private sector savings has been utilized by the public sector to finance its expenditure plans and budget deficits. This level of borrowing led to a very tight liquidity situation in the private sector resulting in considerable difficulties in private sector decision making on investments in capital formation. Thus, the level of investment in the private sector remains highly inadequate to sustain progressive improvements in production.

The conclusion drawn from this comparison is that the growth in capital formation has been brought about by unprecedented spending on development programs and supported by borrowings from both domestic and external sources. The savings behavior of the economy as a whole remained inadequate for a growing economy and this was despite the historically high interest rates maintained by the commercial banking system to attract domestic savings. Unfortunately, high inflationary tendencies eliminated the incentive of higher market interest rates on savings. In fact the real interest rate has been negative throughout, perhaps with 1963 being the only exception.

b) Inflation :

Sri Lanka's inflation remained persistently high after economic and trade liberalization. The Colombo Consumer Price Index rose from 208 in January 1978 to 518 in December 1984 indicating a 150% increase in average prices. Inflation remained unprecedentedly high during 1981-82, averaging over 20% per annum.

INVESTMENT AND SAVINGS TRENDS 1978 - 1983
(RS. MILLION IN CURRENT PRICES)

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
(a) Investments	8,554	13,527	22,465	23,610	30,608	35,146
Public	5,120	6,443	12,307	11,816	15,922	-
Private	3,434	7,084	10,158	11,794	14,686	-
As a % GDP :						
Total	20.0	25.8	33.8	37.8	30.5	-
Public	12.0	12.3	18.5	13.9	15.9	-
Private	8.0	13.5	15.3	13.9	14.7	-
(b) Foreign Investments	31	769	754	1,003	1,377	929
Savings :						
Total	6,517	7,218	7,443	9,944	11,851	16,781
Public	- 821	- 640	-4,398	-3,912	-5,173	-
Private	7,338	7,858	11,841	13,856	17,024	-
As a % GDP :						
Total	15.3	13.8	11.2	11.7	11.8	-
Public	- 1.9	- 1.2	- 6.6	- 4.6	- 5.2	-
Private	17.2	15.0	17.8	16.3	17.0	-

Source : Central Bank of Ceylon
World Bank
Our Computation

The continued reliance on expansionary fiscal and monetary policies appears to have been the most predominant reason for high inflation during the last few years. Expansionary fiscal and monetary policies positively influence money supply through the expansion of domestic credit or, in other words, borrowings by the public and private sectors from the banking system. Money creation through credit expansion in turn causes a positive influence on the rate of inflation. As shown in Table 4, banking credit to the public and private sectors remained as the principal source of money supply throughout the 1980-83 period. Between 1980 and 1983, both public and private sectors became equally significant borrowers from the banking system. However, the full impact of credit creation was not felt on money supply mainly because of a corresponding drop in external assets. The latter in turn implies a close relationship between domestic credit creation and expenditure on imports. In 1984, increasing external banking assets, resulting from higher export earnings became the leading source of money supply.

The most serious implication of high inflation is that it reduces export competitiveness in international markets. In addition, high domestic inflation also attracts imports in the absence of strict import restrictions. Thus inflation causes severe pressures on balance of payments from both exports and imports sides of the equation. The increasing pressure on balance of payments frequently warrants exchange rate devaluations to restore export competitiveness, reduce imports and improve balance of payments. However, if exchange rate depreciation is not adopted within a tight fiscal and monetary policy framework, depreciation often becomes another factor fuelling inflation. In fact, the latter has been the experience in Sri Lanka, as the government continued to rely on expansionary fiscal and monetary policies along with rupee depreciation.

c) Public Debt :

A serious problem that emerged from heavy reliance on borrowings to finance over ambitious development programs was the sharply increasing public debt. It increased by more than three fold between 1978 and 1983, from Rs.27.7 billion in 1978 (foreign Rs.14.6 billion, domestic Rs.13.2 billion) to Rs.86.4 billion in 1983 (foreign 46.0 billion, domestic Rs.40.4 billion). Public debt as a share of GDP increased significantly from 68% in 1978 to 80% in 1983. These measures clearly indicate that Sri Lanka's debt situation is serious by any standard. As a GDP ratio, Sri Lanka ranks first among the South Asian countries.

The size and the composition of the external debt situation assumes greater importance in the present context because of its implications on balance of payments and credit worthiness of the Sri Lankan economy. The composition of Sri Lanka's debt structure experienced substantial changes after 1979 with the government's entry into the commercial market for funds when concessional external assistance became inadequate to support development programs and the current account deficits in the balance of payments. In 1979, the composition of the external debt, showed 73% concessional borrowings, 21% IMF credits, and 6% commercial borrowings. Because of a 13 fold growth in commercial borrowings between 1979 and 1983, the share of commercial borrowings dramatically increased to 33% while the shares of concessional assistance and IMF credits declined to 55% and 12% respectively.

A steady and fast growth in external debt results in increasing debt commitments as well. The debt service ratio in 1979 accounted for 12.4% of

Table 4

SOURCES OF MONEY SUPPLY (RS. MILLION)

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
1. Monetary Aggregates :						
Annual Change in Money Supply (M2)	4,166	4,803	4,587	6,063	6,747	6,171
a) Currency held by Public	759	407	642	1,165	1,212	1,361
b) Demand Deposits held by Public	974	1,352	- 46	571	1,776	715
c) Private Sector Time and Savings Deposits	2,433	3,044	3,990	4,328	3,759	4,095
2. Sources of Money Supply :						
a) Net Credit to the GSL	1,057	6,051	3,817	4,361	383	-2,979
b) Gross Credit to the Public Sector	2,567	5,123	4,513	4,122	6,512	3,612
c) External Banking Assets (net)	1,236	-4,096	- 690	- 569	815	6,772
d) Other Items (net)	- 695	-2,278	3,054	-1,852	- 964	-1,240
3. Annual Increase (%) :						
a) M1	29.2	22.9	6.3	17.3	25.4	14.1
b) M2	38.2	31.9	23.0	24.8	22.1	16.6

Source : Central Bank of Ceylon

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the receipts from merchandise exports, services and private transfers, and in 1983 17.8%. In 1984, the ratio was expected to rise to 21%, but according to tentative estimates, it remained around 18% because of higher export earnings from tea. In the event of lower tea prices in the coming years, the ratio will increase to over 20% as higher export earnings from other sources remain severely limited at the present time.

4. Economic Reforms and Adjustment Policies :

Controlling inflation and promoting exports from traditional as well as non-traditional sources are the two major tasks that confront Sri Lanka in maintaining a viable economy on a sustainable basis over the medium and long-term. Both these issues have a great deal to do with public spending, particularly budget deficits. If budget deficits continue to remain high, both domestic demand pressures and the real effective exchange rates will show a corresponding rise.

The government must place strong emphasis on public expenditure programs which could be financed from revenue resources instead of mobilizing extra budgetary resources as has been done in the past. This emphasis essentially requires the government either curtailing its spending programs or increasing its revenue base or a combination of both. Given the government's prior commitments on various development projects, limited flexibility in reducing recurrent expenditure, and rising expenditure related to defence and security operations, the focus invariably shifts to expanding the revenue base. As the World Bank expects the budget deficit to be less than 10% of GDP by 1987, the government appears to be making considerable efforts to increase revenues. Although little is known so far about the proposals that are under consideration, the focus is likely to be on the expansion of the tax base as well as to increase the elasticity of the tax system.

In addition to improving the budgetary discipline, the divestiture of public sector corporations also should be considered. The current practice of budgetary support to the public sector corporations should be completely withdrawn. Although the government is slowly moving in this direction, there appears to be no significant change in the government policy towards financial support to public corporations. A large number of unprofitable corporations are still depending on the government for budgetary relief, despite the government's policy on no financial support.

The nature of fiscal policy, to a great extent, decides the nature of monetary policy. If the fiscal policy is expansionary, the monetary developments are bound to show expansionary characteristics even in the presence of restrictive measures to control money supply growth. As mentioned earlier, Sri Lanka's money supply growth remained extraordinarily high during the last few years despite strict credit restraints. If the government can finance its public spending programs from its own revenues sources, the pressure on the banking system will be significantly eased which in turn will help to minimize the money supply growth.

Controlling inflation is also crucially important to maintain a viable export sector. As the export prices of domestic products depend on production costs and exchange rates, maintaining export competitiveness requires either lower inflation or exchange rate adjustment. In comparison with Sri Lanka's major trading partners as well as export competitors, Sri Lanka's inflation rate remained persistently high. Theoretically, the difference between the Sri

Lanka's inflation rate and the trading partners/export competitors translates into pressures for a rupee depreciation of the same magnitude.

TABLE 5

EXCHANGE RATE MOVEMENTS AND INFLATION
(% Change)

	U.S. Dollars	Sterling	D.M.	F.F.	Yen	Inflation
1978	-3.02	8.03	16.09	12.02	18.08	12.01
1979	-0.39	9.14	5.22	3.04	-22.85	11.01
1980	16.54	23.52	2.36	2.98	35.66	26.01
1981	12.42	-9.21	-1.61	-11.03	6.16	18.00
1982	3.61	-12.94	-0.95	-12.84	- 2.27	11.01
1983	14.72	3.57	1.37	- 6.66	14.83	13.09
1984	4.51	-14.57	-9.06	-14.57	1.63	16.01
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TOTAL	48.02	7.81	14.64	-26.88	32.16	108.04
	=====	=====	=====	=====	=====	=====

Table 5 compares the exchange rate movements with the rates of inflation during the 1978-84 period. This comparison clearly shows that the Sri Lanka rupee has substantially gone out of line with all major currencies due to rapid domestic inflation. Understandably, this difference in exchange rates and the rate of inflation is the principal reason for growing pressure for a rupee devaluation.

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UNCLAS SECTION 01 OF 06 COLOMBO 00360

TREASURY/OASIA/IDN FOR DEBORAH MCCARTHY ROCHA
STATE PASS AID/PPC/EA FOR KEN KAUFFMAN

E.O. 12356: N/A
TAGS: EFIN, ECON, CE
SUBJECT: FY 85 ECONOMIC POLICY PROFILE (KEMP REPORT):
- SRI LANKA

REF: STATE 369917

1. THIS CABLE PROVIDES INFORMATION REQUESTED IN STATE 369917 FOR AN FY 85 ECONOMIC POLICY PROFILE (KEMP REPORT). PARAGRAPHS AND FORMAT ARE KEYED TO REFTEL.
2. ECONOMIC POLICIES AND PROSPECTS

- A. SRI LANKA IS ESSENTIALLY AN AGRICULTURAL AND TRADING NATION, ALTHOUGH IN RECENT YEARS THERE HAVE BEEN INTENSIVE EFFORTS TO DIVERSIFY INTO EXPORT-ORIENTED LIGHT INDUSTRY. THE COUNTRY'S MAJOR ECONOMIC RESOURCES ARE A HEALTHY, WELL-EDUCATED, LOW-COST LABOR FORCE; A RELATIVELY PRODUCTIVE AGRICULTURAL SECTOR; SOME COMMERCIALY-EXPLOITABLE MINERAL DEPOSITS; HYDROELECTRIC POTENTIAL; AND A WIDE VARIETY OF TOURIST ATTRACTIONS. IN 1977, THE THEN NEWLY-ELECTED UNP GOVERNMENT TURNED FROM THE WELFARE-ORIENTED ECONOMIC POLICIES OF SUCCESSIVE SRI LANKAN GOVERNMENTS SINCE INDEPENDENCE AND INSTITUTED A NUMBER OF POLICY INNOVATIONS AIMED AT STIMULATING GROWTH, PROMOTING ECONOMIC DEVELOPMENT, AND REDUCING UNEMPLOYMENT. FROM 1978-1981, REAL GNP GROWTH AVERAGED MORE THAN 6 PERCENT ANNUALLY. SINCE THEN, GROWTH RATES HAVE BEEN CONSTRAINED BY MORE AUSTERE FISCAL AND MONETARY POLICIES NECESSITATED BY THE OVERHEATING WHICH ACCOMPANIED THE GOVERNMENT'S AMBITIOUS DEVELOPMENT PROGRAMS. LARGE BUDGET DEFICITS FUELED INFLATION, WITH PRICES RISING BY AN AVERAGE 15 PERCENT ANNUALLY OVER THE PAST SEVERAL YEARS. IMPORT LIBERALIZATION IN 1977 RESULTED IN RAPIDLY EXPANDING TRADE AND CURRENT ACCOUNT DEFICITS AND DIMINISHING RESERVES. THE DEBT SERVICE RATIO ALSO BEGAN TO RISE AS THE GSL BORROWED LARGE AMOUNTS ABROAD TO FINANCE ACCELERATED DEVELOPMENT AND A GROWING IMPORT BILL. FORTUITOUSLY, IN 1984 THE WORLD PRICE OF SRI LANKA'S MAJOR EXPORT PRODUCT, TEA, JUMPED. EARNINGS FROM TEA EXPORTS ROSE TO OVER U.S. DOLLARS 500 MILLION IN 1984, RESULTING IN AN OVERALL BALANCE OF PAYMENTS SURPLUS FOR THE FIRST TIME IN SEVERAL YEARS, AN INCREASE IN RESERVES, AND A DECLINE IN THE DEBT SERVICE RATIO. ECONOMIC PROSPECTS FOR 1985 ARE CLOUDY BECAUSE OF THE UNCERTAIN POLITICAL

SITUATION. IF WEATHER CONDITIONS REMAIN FAVORABLE, AND BARRING ANY MAJOR DISRUPTION IN PRODUCTION THROUGHOUT THE YEAR, A GROWTH RATE OF AROUND 5.5 PERCENT IS LIKELY. AS LONG AS TEA PRICES REMAIN HIGH, EXTERNAL PAYMENTS SHOULD REGISTER A SMALL SURPLUS. TOWARDS THE END OF 1984, BOTH THE MONEY SUPPLY AND INFLATION SHOWED SIGNS OF DECELERATION, BUT THIS TREND COULD BE REVERSED IN 1985 IF THERE IS SIGNIFICANT EXCHANGE RATE DEPRECIATION, POLITICAL UNREST, OR BASIC FOOD CROP FAILURE FOR ANY REASON.

- B. SRI LANKA'S POLICY FRAMEWORK AFFECTING PRIVATE INVESTMENT AND COMMERCE WAS SET IN 1977, WHEN THE NEWLY-ELECTED UNP GOVERNMENT INTRODUCED MAJOR POLICY REFORMS. THESE INCLUDED DISMANTLING THE EXTENSIVE SYSTEM OF PRICE, IMPORT, AND FOREIGN EXCHANGE CONTROLS; CHANNELING BUDGETARY RESOURCES INTO A PUBLIC INVESTMENT PROGRAM TO REHABILITATE THE COUNTRY'S INFRASTRUCTURE; AND ENCOURAGING FOREIGN ECONOMIC CONTACTS IN THE FORM OF AID, TRADE, AND INVESTMENT. INSTITUTIONAL INNOVATIONS INCLUDED ESTABLISHMENT OF THE EXPORT DEVELOPMENT BOARD, NATIONAL DEVELOPMENT BANK, PRESIDENTIAL TARIFF COMMISSION, SRI LANKA EXPORT CREDIT INSURANCE CORPORATION, AND THE GREATER COLOMBO ECONOMIC COMMISSION (GCEC), WHICH ADMINISTERS THE INVESTMENT PROMOTION ZONE (IPZ -- POPULARLY KNOWN AS THE FREE TRADE ZONE.) THE IPZ OFFERS TAX HOLIDAYS AND OTHER INCENTIVES TO FOREIGN INVESTMENT IN 100 PERCENT EXPORT-ORIENTED INDUSTRIES. IN ADDITION, MORE LIMITED INCENTIVES ARE AVAILABLE FOR FOREIGN INVESTMENT IN JOINT VENTURES WHICH MARKET SOME OR ALL THEIR PRODUCTS DOMESTICALLY. THE SRI LANKA CONSTITUTION ALSO ADDRESSES THE ISSUE OF FOREIGN INVESTMENT, ENDOWING BILATERAL GOVERNMENT TO GOVERNMENT INVESTMENT TREATIES WITH THE FORCE OF LAW. THE MAJOR POLICY CHANGE IN THE TRADE SYSTEM OVER THE PAST YEAR WAS A READJUSTMENT OF THE EFFECTIVE PROTECTION LEVELS PROVIDED BY IMPORT AND EXPORT DUTIES AND TURNOVER TAXES TO ELIMINATE SOME OF THE BIAS AGAINST LOCAL PRODUCTION AND EXPORTS. THE NEW RATES, WHICH WERE RECOMMENDED AFTER AN EXTENSIVE REVIEW BY THE PRESIDENT'S TARIFF COMMISSION, WERE INTRODUCED

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TREASURY/OASIA/IDY FOR DEBORAH MCCARTHY ROCHA
STATE PASS AID/PPC/EA FOR KEN KAUFFMAN

E.D. 12356: N/A
TAGS: EFIN, ECON, CE
SUBJECT: FY 85 ECONOMIC POLICY PROFILE (MEMP REPORT):

WITH THE 1985 BUDGET IN NOVEMBER 1984. SRI LANKA'S EXCHANGE RATE ARRANGEMENT IS CHARACTERIZED AS "MANAGED FLOATING." REGULATIONS GOVERNING THE FORWARD EXCHANGE MARKET WERE MODIFIED IN MARCH 1984 TO DISCOURAGE SPECULATION AGAINST THE RUPEE AND SPEED UP REPATRIATION OF EXPORT PROCEEDS.

- C. THE ECONOMIC REFORMS OF 1977-78 AND SUBSEQUENT ECONOMIC DEVELOPMENTS HAVE RESULTED IN INCREASED GROWTH RATES, A DECLINE IN UNEMPLOYMENT, BUT ALSO A LARGE IMBALANCE BETWEEN NATIONAL SAVINGS AND INVESTMENT. REAL GROWTH AVERAGED 6 PERCENT FROM 1978-1983. AGRICULTURAL PRODUCTION IN GENERAL, AND PADDY OUTPUT IN PARTICULAR, HAVE RESPONDED VERY WELL TO THE ELIMINATION OF PRICE CONTROLS. SRI LANKA IS NOW ON THE VERGE OF SELF-SUFFICIENCY IN RICE PRODUCTION, AND HAS INCREASED ITS OUTPUT OF SUBSIDIARY FOOD CROPS. THE PLANTATION SECTOR, ON THE OTHER HAND, HAS SUFFERED FROM LONG PERIODS OF INADEQUATE INVESTMENT. ON THE INDUSTRIAL SIDE, RESULTS HAVE BEEN MIXED. FREE TRADE ZONE INCENTIVES ATTRACTED CONSIDERABLE PRIVATE INVESTMENT FROM 1978-82, BUT IT WAS HEAVILY CONCENTRATED IN TEXTILES AND GARMENTS. SINCE THE IMPOSITION OF QUOTAS AND OTHER RESTRICTIONS BY DEVELOPED COUNTRIES, INVESTMENT IN THIS SECTOR HAS COME TO A HALT. OUTSIDE THE FREE TRADE ZONE, INVESTMENT FLOWED INTO REAL ESTATE AND TOURIST HOTELS, WHERE INVESTORS COULD EXPECT RAPID RETURNS ON THEIR MONEY. THERE WAS ALSO A SURGE IN CONSTRUCTION ACTIVITY AS A RESULT OF THE EXPANSION IN PUBLIC INVESTMENT, BUT CONSTRUCTION GROWTH HAS BEEN SLOW SINCE 1981. SINCE 1980, SERVICES HAVE BEEN THE PRIMARY CONTRIBUTOR TO GDP GROWTH. PRIVATE SECTOR EXPANSION SINCE 1977-78 HAS BEEN CONCENTRATED IN AREAS WHERE INCENTIVES ARE GREATEST AND RETURNS HIGHEST: TRADE, TOURISM, REAL ESTATE, AND PRIVATE OMNIBUS TRANSPORT. FEW PRIVATE RESOURCES HAVE FLOWED INTO DOMESTIC MANUFACTURING CONCERNS BECAUSE DISINCENTIVES -- AN OVERVALUED EXCHANGE RATE, BIAS AGAINST EXPORTS AND LOCAL PRODUCTION IN THE TARIFF AND TAX STRUCTURE, POOR INFRASTRUCTURE, HIGH INTEREST RATES, AND THE UNAVAILABILITY OF MEDIUM AND LONG-TERM FINANCE -- HAVE OUTWEIGHED INCENTIVES.

D. AVERAGE ANNUAL GROWTH RATES (PERCENT)

	1970-1980	1980-1983
(1) REAL PER CAPITA INCOME	2.4	2.8
(2) M1 (CASH AND CHECKING DEP.)	17.8	16.3
(3) SAVINGS AND TIME DEPOSITS	29.7	31.9
(4) RATIO OF TAXES TO GDP	17.4	16.9
(5) GOP DEFLATOR	12.5	15.4

3. POLICY INDICATORS

A. MAJOR DETERMINANTS OF MONEY SUPPLY

(1) RELATIVE ORDER OF INFLUENCE UPON THE MONEY SUPPLY:

- (A) GOVERNMENT DEFICITS
- (B) CREDIT TO AGRICULTURE
- (C) CREDIT TO EXPORTERS
- (D) CREDIT TO IMPORTERS
- (E) CREDIT TO PARASTATALS
- (F) CREDIT TO MANUFACTURERS
- (G) FOREIGN EXCHANGE FLOWS

(FOOTNOTE): ACTUALLY, FOREIGN EXCHANGE FLOWS WERE THE MOST SIGNIFICANT DETERMINANT OF THE MONEY SUPPLY IN 1984, BUT THIS WAS AN ANOMALOUS SITUATION RESULTING FROM THE HIGH TEA PRICES AND UNUSUALLY HIGH INFLOWS OF FOREIGN EXCHANGE FROM TEA EXPORTS. THEREFORE WE HAVE PLACED THE ABOVE FACTORS IN THE ORDER OF USUAL INFLUENCE UPON THE MONEY SUPPLY.

(2) RELATIVE ORDER OF IMPORTANCE OF POLICY TOOLS IN CONTROLLING MONEY SUPPLY:

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TREASURY/OASIA/IDN FOR DEBORAH MCCARTHY ROCHA
STATE PASS AID/PPC/EA FOR KEN KAUFFMAN

E.D. 12356: N/A
TAGS: EFIM, ECON, CE
SUBJECT: FY 85 ECONOMIC POLICY PRGFILE (MEMP REPORT):

- (A) ADMINISTRATIVE CONTROLS (CREDIT
CELINGS, ETC.)
- (B) ADJUSTMENT OF RESERVE REQUIREMENTS
- (C) ADJUSTMENTS IN THE DISCOUNT RATE
- (D) ADMINISTRATION OF INTEREST RATES
- (E) OPEN MARKET OPERATIONS (SALE OF
GOVERNMENT SECURITIES)

8. EXCHANGE RATE POLICIES

(1) SRI LANKA HAS A "MANAGED" FLOATING
EXCHANGE RATE POLICY, THE RATE IS SET EVERY
DAY BY THE CENTRAL BANK, AND IN PRACTICE IT
HAS FOLLOWED MOVEMENTS OF THE DOLLAR MOST
CLOSELY.

(2) CURRENT MAJOR FOREIGN EXCHANGE CONTROLS:

EXCHANGE CONTROL IS ADMINISTERED BY THE
DEPARTMENT OF EXCHANGE CONTROL OF THE
CENTRAL BANK AS AGENT OF THE GOVERNMENT.
THE CONTROLLER OF EXCHANGE IS THE AUTHORITY
FOR MAKING REGULATIONS IN RESPECT OF
EXCHANGE CONTROL REQUIREMENTS. LISTED
BELOW ARE SOME OF THE MAJOR FOREIGN
EXCHANGE CONTROLS.

(A) ALL REMITTANCES OF FOREIGN EXCHANGE IN
SRI LANKA MUST NORMALLY BE MADE THROUGH
COMMERCIAL BANKS AUTHORIZED TO CARRY OUT
OPERATIONS IN FOREIGN CURRENCIES IN
ACCORDANCE WITH EXCHANGE CONTROL FACILITIES
PRESCRIBED BY THE CONTROLLER OF EXCHANGE.

(B) IMPORTS AND IMPORT PAYMENTS: EXCEPT
FOR CERTAIN SPECIFIED IMPORTS, NO PRIOR
LICENCING IS REQUIRED. IMPORTS THAT ARE
SUBJECT TO PRIOR LICENCING INCLUDE THOSE
SUBJECT TO CONTROL FOR SECURITY REASONS.
THESE ITEMS INCLUDE PRECIOUS METALS,
ALCOHOL, NEWSPRINT, FROZEN POULTRY AND
CERTAIN CONSUMER GOODS. IMPORTS OF
SPECIFIED ITEMS ARE REFERRED TO AS

"RESERVED ITEMS". PRIOR APPROVAL
PROCEDURES APPLY TO CERTAIN IMPORTS OF
CAPITAL GOODS, SUCH AS MACHINERY IMPORTS
RELATING TO FOREIGN INVESTMENT. EXCEPT FOR
SPECIFIED RESTRICTIONS IMPORTS CAN BE
EFFECTED BY LETTERS OF CREDIT.

(C) EXPORTS TO COUNTRIES WITH WHICH SRI
LANKA MAINTAINS BILATERAL PAYMENTS ARE
SUBJECT TO THE APPROVAL OF THE DIRECTOR OF
COMMERCE. A NUMBER OF SPECIFIED ITEMS
REQUIRE PRIOR LICENCING BY THE CONTROLLER
OF IMPORTS AND EXPORTS. RE-EXPORTS OF
NON-MONETARY GOLD, SILVER, DIAMONDS AND
PLATINUM ARE ALLOWED ONLY IN SPECIAL CASES.
(D) IMPORTS AND EXPORTS OF GOLD IN ANY FORM
REQUIRE LICENCES ISSUED BY THE CONTROLLER
OF IMPORTS AND EXPORTS WITH THE APPROVAL OF
THE CONTROLLER OF EXCHANGE. COMMERCIAL
ARTICLES CONTAINING GOLD AND SILVER ARE
SEVERELY RESTRICTED.

(E) INWARD REMITTANCE OF FOREIGN EXCHANGE
PROCEEDS FROM EXPORTS U.S. DOLLARS \$5,000 A
TRANSACTION AND ABOVE REQUIRES PRIOR
APPROVAL OF THE CONTROLLER OF EXCHANGE.

(F) FOREIGN EXCHANGE PROCEEDS FROM
INVISIBLES MUST BE SURRENDERED. A
TRAVELLER ENTERING SRI LANKA MUST DECLARE
HIS HOLDINGS INCLUDING CURRENCY AND COINS.

(G) CERTAIN PAYMENTS FOR INVISIBLES REQUIRE
EXCHANGE CONTROL PERMISSION. FOR TRAVEL
ABROAD RESIDENTS OF SRI LANKA ARE ALLOWED A
BASIC FOREIGN EXCHANGE ALLOWANCE OF INDIAN
RUPEES 2,000 FOR TRAVEL TO INDIA AND 500
BRITISH POUNDS ARE ALLOWED EVERY 4 YEARS
FOR TRAVEL TO OTHER COUNTRIES. FOR
BUSINESS TRAVEL EXCHANGE IS ALLOWED AT THE

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R 170521Z JAN 85
FM AMEMBASSY COLOMBO
TO SECSTATE WASHDC 0715
DEPARTMENT OF TREASURY WASHDC

UNCLAS SECTION 05 OF 06 COLOMBO 00380

TREASURY/OASIA/IDM FOR DEBORAH MCCARTHY ROCHA
STATE PASS AID/PPC/EA FOR KEN KAUFFMAN

E.O. 12356: N/A
TAGS: EFIN, ECON, CE
SUBJECT: FY 85 ECONOMIC POLICY PROFILE (KEHP REPORT):

GOVERNMENT SUBSIDIZES THE COST OF KEROSENE THROUGH THE CEYLON PETROLEUM CORPORATION. FERTILIZER IS ALSO SUBSIDIZED THROUGH THE STATE FERTILIZER CORPORATION. THE WATER AND POWER COMPANIES CHARGE ON A SLIDING SCALE, WITH HIGHER RATES AS CONSUMPTION INCREASES.

F. INVESTMENT AND SAVINGS POLICIES:

1. MAJOR PARASTATAL ENTERPRISES:

STATE-OWNED ENTERPRISES DOMINATE SRI LANKA'S INDUSTRIAL SECTOR. THEY ACCOUNT FOR AROUND TWO-THIRDS OF INDUSTRIAL OUTPUT AND FIXED CAPITAL, AND OVER HALF OF INDUSTRIAL EMPLOYMENT.

(A) CEYLON PETROLEUM CORPORATION: ACCOUNTS FOR 50 PERCENT OF TOTAL PUBLIC SECTOR INDUSTRIAL OUTPUT AND 100 PERCENT OF REFINERY OPERATIONS.

(B) STATE FERTILIZER CORPORATION: ACCOUNTS FOR 100 PERCENT OF LOCAL FERTILIZER MANUFACTURE (NAPHTHA-BASED).

(C) SRI LANKA CEMENT CORPORATION: 100 PERCENT LOCAL CEMENT MANUFACTURE (OTHER PRIVATE COMPANIES PACKAGE IMPORTED CEMENT).

(D) NATIONAL TEXTILE: 15 PERCENT OF GARMENT AND TEXTILE MANUFACTURE.

(E) STATE TIMBER CORPORATION: 90 PERCENT OF FORESTRY MANUFACTURE.

(F) NATIONAL PAPER CORPORATION: 100 PERCENT OF LOCAL PAPER MANUFACTURE.

(G) SRI LANKA SUGAR CORPORATION: 100 PERCENT OF LOCAL SUGAR MANUFACTURE.

(H) STATE DISTILLERIES CORPORATION: 70 PERCENT OF LOCAL SPIRIT MANUFACTURE.

(I) CEYLON STEEL CORPORATION: 100 PERCENT LOCAL STEEL MANUFACTURE.

(J) STATE PLANTATION CORPORATION: 30 PERCENT PLANTATION CROP PRODUCTION.
(K) JANATHA ESTATES DEVELOPMENT BOARD: 35 PERCENT PLANTATION CROP PRODUCTION.

(L) NATIONAL SALT CORPORATION: 100 PERCENT LOCAL EXTRACTION AND MARKETING OF SALT.

(M) LANKA PORCELAIN LIMITED: LIMITED LIABILITY COMPANY CONTROLLED BY THE GOVERNMENT, INVOLVED IN 70 PERCENT OF LOCAL MANUFACTURE OF PORCELAIN WARE.

(N) VIJAYA TILES LIMITED AND NOORANI TILE WORKS: VESTED UNDERTAKINGS OF THE GOVERNMENT INVOLVED IN 60 PERCENT OF THE PRODUCTION OF TILES FOR LOCAL CONSUMPTION.

2. AND 3. INCENTIVES/DISINCENTIVES FOR INVESTMENT:

(A) INCENTIVES FOR DOMESTIC PRIVATE INVESTMENT:

TAX HOLIDAYS FOR NON-TRADITIONAL EXPORT INDUSTRIES.
TAX DEDUCTIONS FOR CAPITAL EXPENDITURE IN AGRICULTURE AND FISHERIES.
EXPORT EXPANSION GRANTS,
CUSTOMS DUTY REBATES.
FINANCE ON CONCESSIONARY TERMS FROM DEVELOPMENT BANKS.

(B) INCENTIVES FOR FOREIGN INVESTMENT:

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R 170521Z JAN 85
FM AMEMBASSY COLOMBO
TO SECSTATE WASHDC 8716
DEPARTMENT OF TREASURY WASHDC

UNCLAS SECTION 06 OF 06 COLOMBO 00380

TREASURY/OASIA/IDN FOR DEBORAH MCCARTHY ROCHA
STATE PASS AID/PPC/EA FOR KEN KAUFFMAN

E. O. 12356: N/A
TAGS: EFIN, ECON, CE
SUBJECT: FY 85 ECONOMIC POLICY PROFILE (KEMP REPORT):

- LOW-COST, WELL-EDUCATED LABOR FORCE.
- GCEC:
- TAX HOLIDAYS.
- 100 PERCENT FOREIGN OWNERSHIP ALLOWED.
- FREE TRANSFER OF SHARES.
- DUTY-FREE IMPORT OF MACHINERY.
- (C) DISINCENTIVES FOR PRIVATE DOMESTIC AND FOREIGN INVESTMENT:
- UNCERTAINTY ABOUT GOVERNMENT POLICY.
- UNCERTAINTY IN THE POLITICAL SITUATION.
- LACK OF SUFFICIENT RESOURCES (CAPITAL, LABOUR, MACHINERY).
- MARKET UNCERTAINTY (PRICES, DEMAND, IMPORTS, ETC.).
- OVERVALUED EXCHANGE RATE.
- FAULTY TARIFF STRUCTURE THAT ENCOURAGES IMPORTS OVER LOCAL MANUFACTURE.
- HIGH INTEREST COST AND UNAVAILABILITY OF MEDIUM AND LONG-TERM FINANCE.
- POOR AND DETERIORATING INFRASTRUCTURE.
- HIGH COST OF ENERGY.
- EXCESSIVE NUMBER OF NON-WORKING DAYS.
- 4. SRI LANKA IS NOT A DONOR NATION. IN 1984, THE GSL PROVIDED SMALL AMOUNTS OF FOOD AID AS A TOKEN DONATION TO POOR COUNTRIES SUCH AS THE MALDIVES AND TANZANIA.

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JUS-01 USIE-00 SP-02 OOE-00 SNP-01 SPD-01 /069 W
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R 170516Z MAY 85
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INFO USDA FAS WASHDC
DEPARTMENT OF TREASURY WASHDC
USDOC WASHDC

UNCLAS COLOMBO 03359

DEPT PASS OPIC EXIMBANK, AID

F.O. 12356: N/A
TAGS: ECON, EFIM, CE
SUBJECT: SRI LANKAN ECONOMIC INDICATORS THROUGH DECEMBER 1984

1. SUMMARY: THE CENTRAL BANK ESTIMATES A 5.1 PERCENT INCREASE IN GDP FOR 1984, AND PER CAPITA INCOME FOR THE YEAR AT RS. 8,643 (U.S. DOLLARS 340). TEA PRODUCTION RECORDED A 16 PERCENT INCREASE DURING THE YEAR, WHILE COCONUT PRODUCTION DROPPED BY 17 PERCENT. TOURIST ARRIVALS REGISTERED A SLIGHT UPTURN IN DECEMBER, SUGGESTING A POSSIBLE RECOVERY, BUT ARRIVALS FOR THE YEAR WERE 6 PERCENT LESS THAN IN 1983. THE ENCOURAGING DEVELOPMENTS DURING THE PERIOD WERE THE NARROWING BUDGET AND TRADE DEFICITS, AN INCREASE IN EXTERNAL RESERVES, AND A SLOWING OF INFLATION. PUBLIC DEBT OUTSTANDING WIDENED CONSIDERABLY. THE RUPEE CONTINUED TO DEPRECIATE AGAINST THE DOLLAR.

2. VIS-A-VIS 1983. RUBBER PRODUCTION FOR THE FIRST EIGHT MONTHS OF THE YEAR REGISTERED AN INCREASE OF 7 PERCENT OVER THE SAME PERIOD IN 1983. COCONUT PRODUCTION DURING DECEMBER APPEARED TO BE IMPROVING, RECORDING AN INCREASE OF 7 PERCENT OVER DECEMBER 1983, BUT PRODUCTION FOR THE YEAR AS A WHOLE DECLINED BY 17 PERCENT. PUBLIC SECTOR INDUSTRIAL ENTERPRISES RECORDED A 7 PERCENT INCREASE IN OUTPUT DURING 1984, MAINLY ATTRIBUTABLE TO THE 22 PERCENT RISE IN THE OUTPUT OF THE PETROLEUM CORPORATION WHICH OPERATED WITHOUT ANY SHUTDOWNS IN 1984.

3. TOURISM: TOURIST ARRIVALS DURING DECEMBER 1984 AMOUNTED TO 29,590, A MARGINAL INCREASE OF 0.8 PERCENT OVER THE CORRESPONDING MONTH OF THE PREVIOUS YEAR. CUMULATIVE TOURIST ARRIVALS FOR 1984 DECLINED BY 6 PERCENT FROM 337,530 IN 1983 TO 317,734 IN 1984, BUT THE DOWNTURN WAS EVEN GREATER -- 22 PERCENT-- WHEN COMPARED WITH 1982 TOURIST ARRIVALS. THE GREATEST REGIONAL DECREASE CAME FROM ASIA, WHICH RECORDED A 28 PERCENT DROP FROM 1983. TOURISTS FROM WESTERN EUROPE, THE LARGEST SOURCE, INCREASED BY 8 PERCENT VIS-A-VIS 1983, BUT WERE STILL 22 PERCENT BELOW THE RECORD NUMBER OF EUROPEAN ARRIVALS REACHED IN 1981.

4. BUDGET: GOVERNMENT REVENUE IN DECEMBER 1984 AMOUNTED TO RS. 4,000 MILLION AND REFLECTED AN INCREASE OF 7 PERCENT OVER THE SAME MONTH IN 1983. THIS INCREASE CAN BE ATTRIBUTED TO HIGHER RECEIPTS FROM TEA AND TOBACCO TAXES. REVENUE COLLECTIONS FOR THE YEAR ARE ESTIMATED AT RS. 36,600 MILLION, AN INCREASE OF 45 PERCENT OVER THE CORRESPONDING PERIOD IN THE PRECEDING YEAR. EXPENDITURE

IN DECEMBER AMOUNTED TO RS. 11,802 MILLION. CUMULATIVE EXPENDITURE FOR 1984 AMOUNTED TO RS. 51,887 MILLION, AND RECORDED AN INCREASE OF 15 PERCENT OVER THE EXPENDITURE FOR 1983. THE BUDGET DEFICIT THUS REACHED RS. 15,287 MILLION, AN IMPROVEMENT OVER THE RS. 21,557 MILLION DEFICIT IN 1983. RECURRENT EXPENDITURE FOR 1984, AT RS. 29,947 MILLION INDICATED, AN INCREASE OF 25 PERCENT WHILE CAPITAL EXPENDITURE (EXCLUSIVE OF SINKING FUNDS), AT RS. 21,940 MILLION, RECORDED AN INCREASE OF 21 PERCENT.

6. MONEY SUPPLY: IN DECEMBER 1984, M 1 (NARROW MONEY SUPPLY) INCREASED BY 7 PERCENT AND STOOD AT RS. 16.8

BILLION. FOR 1984 AS A WHOLE, M 1 ROSE 14 PERCENT, AN IMPROVEMENT OVER THE 25 PERCENT INCREASE IN 1983. M 2 REGISTERED AN INCREASE OF 3 PERCENT OVER DECEMBER 1983 REACHING RS. 43.4 MILLION, AND GREW BY 17 PERCENT THROUGHOUT 1984, VIS-A-VIS 22 PERCENT IN 1983. A NOTEWORTHY DEVELOPMENT DURING DECEMBER WAS THE SIGNIFICANT INCREASE IN THE MONETARY BASE, A RESULT OF INCREASES IN CENTRAL BANK RESERVES AND NET CREDIT TO THE GOVERNMENT. DURING 1984, THE MAJOR FACTORS DETERMINING THE NET CHANGE IN M 2 WERE A 213 PERCENT INCREASE IN EXTERNAL BANKING ASSETS, A 17 PERCENT DECREASE IN NET CREDIT TO THE GOVERNMENT (CENTRAL BANK CREDIT DROPPED WHILE COMMERCIAL BANK CREDIT ROSE), AND AN 11 PERCENT INCREASE IN GROSS CREDIT TO THE PRIVATE SECTOR.

7. PRICES: IN DECEMBER 1984 THE WPI DECREASED BY 1.3 PERCENT COMPARED WITH 0.6 PERCENT INCREASE OVER THE PREVIOUS MONTH, MAINLY BECAUSE OF A DROP IN FOOD PRICES. FOR 1984 AS A WHOLE, ON A POINT-TO-POINT BASIS THE WHOLESALE PRICE INDEX INCREASED BY 5.3 PERCENT COMPARED TO A 44 PERCENT INCREASE IN THE CORRESPONDING PERIOD IN THE PREVIOUS YEAR. THE AVERAGE ANNUAL INCREASE FOR 1984, AT 25.6 PERCENT, WAS ALMOST THE SAME AS 25 PERCENT REACHED IN 1983. THE APRIL 1984 TO APRIL 1985 CHANGE IN THE CONSUMER PRICE INDEX WAS 2 PERCENT WHILE THE CHANGE IN THE CORRESPONDING 1983/1984 PERIOD WAS 19 PERCENT. AS REPORTED IN PREVIOUS CABLES, THE 1984 POINT-TO-POINT INCREASE IN THE CPI WAS 9 PERCENT, WHILE THE AVERAGE REACHED 16.6 PERCENT.

8. BALANCE OF PAYMENTS: TOTAL EXPORT EARNINGS FOR 1984 AMOUNTED TO RS. 37,347 MILLION (SDR 1,432 MILLION), AN INCREASE OF 49 PERCENT IN RUPEE TERMS AND 43 PERCENT IN SDRS. TOTAL EXPENDITURE ON IMPORTS AMOUNTED TO RS. 47,711 MILLION (SDR 1,829 MILLION) RECORDING AN INCREASE OF 5 PERCENT OVER 1983 IN RUPEE TERMS AND ONE PERCENT IN SDR TERMS. EXPORT EARNINGS FROM TEA, RUBBER, COCONUTS, GARMENTS AND PETROLEUM PRODUCTS INCREASED, WHILE MINOR AGRICULTURAL EXPORTS DECLINED AS COMPARED WITH 1983. ON THE IMPORT SIDE, EXPENDITURE ON INTERMEDIATE AND INVESTMENT GOODS WAS HIGHER, WHILE OUTLAYS FOR RICE AND SUGAR DECLINED VIS-A-VIS 1983. THE TRADE DEFICIT FOR 1984 WAS RS. 10,345 MILLION (SDR 397 MILLION), AS AGAINST A MUCH HIGHER DEFICIT OF RS. 20,461 MILLION (SDR 813 MILLION) IN 1983, SHOWING SUBSTANTIAL IMPROVEMENT.

9. EXCHANGE RATE: DURING DECEMBER THE SRI LANKA RUPEE APPRECIATED BY 4.2 PERCENT AGAINST THE POUND STERLING, 1.8 PERCENT AGAINST THE JAPANESE YEN AND 1.4 PERCENT AGAINST THE DEUTSCHE MARK WHILE IT DEPRECIATED BY 0.7 PERCENT AGAINST THE U.S. DOLLAR. FOR 1984 AS A WHOLE, THE RUPEE APPRECIATED BY 17.6 PERCENT AGAINST THE POUND STERLING, 9.1 PERCENT AGAINST THE DEUTSCHE MARK, 2.1 PERCENT AGAINST THE JAPANESE YEN, AND 1.2 PERCENT AGAINST THE SDR WHILE IT DEPRECIATED BY 4.9 PERCENT AGAINST THE U.S. DOLLAR VIS-A-VIS 1983. ON MAY 10 1985, THE RATE WAS US DOLLAR 1RS. 27.42

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KEY ECONOMIC INDICATORS THROUGH DECEMBER, 1984

INDICATOR	1983	(A) 1983	(B) 1984	PERCENTAGE
MERCHANDISE EXPORTS, FOB, ADJUSTED (MN RUPEES)	25,096	25,096	37,347	49
MERCHANDISE IMPORTS, CIF ADJUSTED (MN RUPEES)	45,558	45,558	47,711	5
TRADE BALANCE (MN RUPEES)	-20,461	-20,461	-10,345	-40
TEA EXPORTS (MN RUPEES)	8,295	8,295	15,764	90
RUBBER EXPORTS (MN RUPEES)	2,852	2,852	3,301	16
COCONUT EXPORTS (MN RUPEES)	1,921	1,921	2,118	10
PETROLEUM PRODUCTS EXPORTS (MN RUPEES)	2,682	2,682	3,288	23
TEXTILE/GARMENT EXPORTS (MN. RUPEES)	4,738	4,738	7,535	59
OTHER MFG. EXPORTS (MN. RUPEES) (2)	1,402	1,402	1,769	26
CRUDE OIL IMPORTS (MN. RUPEES)	11,024	11,024	10,681	- 3
GROSS EXTERNAL ASSETS (MN RUPEES)	12,840 (END DEC)	13,062 (END DEC)	18,942 (END DEC)	45
EXTERNAL DEBT OUTSTANDING (3) (MN RUPEES)	46,025 (END DEC)	46,025 (END DEC)	53,681 (END DEC)	17
EXCHANGE RATE MID-RATE (RS/DOLS) (1) BASED ON 5 PERCENT SAMPLE OF PUBLIC CORPORATIONS, WHICH IN TURN ACCOUNT FOR 10-15 PERCENT OF GDP.	23.62 (AVG)	25.14 (END APRIL)	27.22 (END APRIL)	-

(2) INCLUDES FOOD, BEVERAGES, TOBACCO, CHEMICAL PRODUCTS,
LEATHER, RUBBER, WOOD, CERAMICS, CEMENT, MACHINERY,
AND MECHANICAL PRODUCTS.

(3) PUBLIC DEBT ONLY. TOTAL EXTERNAL DEBT OUTSTANDING
YE 1984 WAS RS. 74,320

SOURCE: CENTRAL BANK BULLETIN JANUARY 1984, AND
UNPUBLISHED DATA

PREPARED BY: RCALOYSIUS

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TO SECSTATE WASHDC 9163
INFO AMEMBASSY BANGKOK

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AIDAC

FOR ASIA DP FOR MICHAEL CROSSWELL

E.O. 12356: N/A

SUBJECT: SRI LANKA'S CAPACITY TO SERVICE HG LOANS

REF: (A) 12/24/84 MEMO CROSSWELL TO CORREL, (B) 7/23/84
- IMF, SRI LANKA - RECENT ECONOMIC DEVELOPMENTS,
- (C) 5/4/83 WORLD BANK, SRI LANKA - AN INTERIM
- ASSESSMENT OF EXPERIENCE AND PRIORITIES, (D) 5/27/82
- WORLD BANK, ECONOMIC ADJUSTMENT IN SRI LANKA -
- ISSUES AND PROSPECTS

1. SUMMARY: THE ISSUE PRESENTED BY REF (A) IS WHETHER, CONSIDERING CERTAIN STRUCTURAL PROBLEMS IN THE SRI LANKAN ECONOMY, IT MAKES SENSE TO PROVIDE ADDITIONAL HG LENDING IN THAT COUNTRY. USAID'S VIEW IS THAT ALTHOUGH IT IS NOT POSSIBLE TO MEANINGFULLY EVALUATE THE CREDITWORTHINESS OF ANY COUNTRY OVER THE LONG TERMS OF HG LENDING, RECENT MACRO-ECONOMIC DEVELOPMENTS MAKE SUCH LENDING PRUDENT FOR THE FORESEEABLE FUTURE IN THE PRINCIPAL AMOUNTS CURRENTLY CONTEMPLATED. END SUMMARY.

2. THE TENTATIVE CONCLUSION OF THE ASIA BUREAU (REF A) IS THAT WEAKNESSES IN THE UNDERLYING STRUCTURE OF THE BALANCE OF PAYMENTS MAKE THE PROSPECTIVE CAPACITY OF SRI LANKA TO AMORTIZE ITS DEBT TOO UNCERTAIN TO WARRANT ADDITIONAL HG LENDING. THIS POSITION APPEARS TO BE DERIVED FROM THE JUNE 1984 IMF REPORT, WHICH WAS IN TURN BASED UPON TRENDS REFLECTING THE 1979 TO 1983 PERIOD. AT THE END OF 1983, SRI LANKA'S EXTERNAL DEBT TOTALLED SDR 2.8 BILLION (DOLLAR 2.93 BILLION) INCREASING FROM SDR 1.1 BILLION (DOLLAR 1.43 BILLION) AT THE END OF 1979. AS A RATIO TO GDP, EXTERNAL DEBT INCREASED FROM 40 PERCENT IN 1979 TO 58 PERCENT IN 1983. THE OVERALL DEBT SERVICE RATIO PROGRESSIVELY INCREASED FROM 12.1 PERCENT IN 1979 TO 22.0 PERCENT IN 1983. HOWEVER, SUBSEQUENT EVENTS ARGUE FOR A MORE POSITIVE EVALUATION OF SRI LANKA'S FUTURE DEBT-SERVICING CAPACITY.

3. THE FAVORABLE INTERNATIONAL TEA PRICES SINCE THE FINAL QUARTER OF 1983 YIELDED AN ADDITIONAL DOLLAR 250 MILLION WORTH OF FOREIGN EXCHANGE IN 1984, COMPARED TO 1983 EARNINGS OF DOLLAR 353 MILLION FROM TEA. AVERAGE TEA PRICES INCREASED 46 PERCENT IN 1984 OVER 1983. THE BALANCE OF PAYMENTS POSITION IN 1984 IMPROVED DRAMATICALLY WITH THE CURRENT ACCOUNT DEFICIT DECLINING FROM DOLLAR 480 MILLION IN 1983 TO DOLLAR 350 MILLION IN 1984. THE DEBT SERVICE RATIO DROPPED TO AN ESTIMATED 17 PERCENT AND THE GROSS EXTERNAL RESERVE POSITION INCREASED TO A VERY RESPECTABLE TOTAL OF AROUND DOLLAR 700 MILLION, EQUIVALENT TO ABOUT FIVE MONTHS OF IMPORTS. IF THIS TREND CONTINUES DURING THE NEXT 3 TO 4 YEARS, THE BALANCE OF PAYMENTS OUT-

LOOK IS LIKELY TO REMAIN FAVORABLE DURING THE MEDIUM-TERM. SINCE THIS IS MOSTLY CONDITIONAL ON INTERNATIONAL TEA PRICES, IT IS NECESSARY TO BRIEFLY LOOK AT THE PROSPECTS OF CONTINUING HIGHER TEA PRICES OVER THE NEXT FEW YEARS.

4. ALTHOUGH THE IMF AND THE WORLD BANK CONSIDER THE HIGHER INTERNATIONAL TEA PRICES AS ESSENTIALLY SHORT-TERM PHENOMENA, NOT LASTING MUCH BEYOND 1985, TEA EXPERTS HERE BELIEVE THAT THE TREND SHOULD LAST AT LEAST 3 TO 5 YEARS. SINCE THE BEGINNING OF 1982, THERE HAS BEEN A CONTINUING SHORTFALL IN THE WORLD'S TEA SUPPLY, RELATIVE TO THE INTERNATIONAL DEMAND FOR TEA, TOTALLING 100 MILLION KGS AT THE BEGINNING OF 1984. DUE TO PRODUCTION INCREASES IN INDIA, SRI LANKA AND OTHER TRADITIONAL TEA PRODUCING COUNTRIES, THE SHORTFALL IS REPORTED TO HAVE BEEN REDUCED TO NEARLY HALF DURING 1984. EVEN WITH MODEST INCREASES IN ANNUAL TEA PRODUCTION, THIS SUPPLY SHORTFALL IS LIKELY TO PERSIST DURING THE NEXT FEW YEARS BECAUSE OF THE ESTIMATED ANNUAL 2.5 PERCENT GROWTH IN WORLDWIDE TEA DEMAND WHICH TRANSLATES TO AN ADDITIONAL ANNUAL REQUIREMENT OF 40 MILLION KGS. AS THE WORLD'S LARGEST PRODUCER AND CONSUMER OF TEA, IT APPEARS THAT ONLY A DECISION TO LIFT TEA EXPORT CONTROLS IN INDIA COULD REDUCE OR ELIMINATE THE SHORTFALL DURING THE MEDIUM-TERM. INDIA HOWEVER, IS CONSTRAINED BY ITS OWN RAPIDLY GROWING INTERNAL DEMAND.

5. INDIA'S TEA PRODUCTION IN 1984 IS ESTIMATED TO HAVE REACHED AN ALL TIME HIGH OF 635,000 METRIC TONS. THE TENTATIVE FORECAST FOR 1985 IS BETWEEN 645,000 TO 650,000 METRIC TONS. THE INDIAN TEA BOARD ESTIMATES THE 1984 TEA EXPORT VOLUME TO BE AROUND 215,000 METRIC TONS, COMPARED TO 200,500 METRIC TONS IN 1983, AND PROJECTS THE 1985 EXPORT VOLUME TO BE IN THE REGION OF 220,000 METRIC TONS. IN 1984, DOMESTIC CONSUMPTION HAS BEEN ESTIMATED TO BE 400,000 METRIC TONS AND THIS IS EXPECTED TO INCREASE TO 416,000 METRIC TONS IN 1985. THE PROJECTED INCREASE IN DOMESTIC TEA CONSUMPTION IN 1985 FULLY ABSORBS THE PROJECTED INCREASE IN PRODUCTION. ACCORDINGLY, IF THE PRODUCTION TARGET IS NOT MAINTAINED, THE PROJECTED EXPORT TARGET CAN BE MAINTAINED ONLY AT THE EXPENSE OF DOMESTIC CONSUMPTION WHICH IN TURN COULD LEAD TO HIGHER DOMESTIC TEA PRICES. EVEN WITH TEA EXPORT CONTROLS, IT HAS BEEN REPORTED THAT DOMESTIC TEA PRICES IN 1984 INCREASED BY 25 PERCENT. AS SUCH, THE LIKELIHOOD OF COMPLETELY LIFTING INDIAN EXPORT CONTROLS ON TEA OR SUBSTANTIALLY INCREASING THE VOLUME OF TEA EXPORTS FROM THE CURRENT LEVELS APPEARS UNLIKELY AND, THEREFORE, A CONSIDERABLE DEGREE OF STABILITY IN THE PREVAILING INTERNATIONAL TEA PRICES SHOULD PREVAIL IN THE MEDIUM-TERM. BEYOND THE MEDIUM-TERM IT IS POSSIBLE THAT THE WORLD'S TEA SUPPLY WILL INCREASE DUE TO EXPANSION IN THE AREA UNDER CULTIVATION IN TRADITIONAL TEA GROWING COUNTRIES AS WELL AS NEW ENTRY TO THE MARKET BY NON-TRADITIONAL TEA GROWING COUNTRIES.

6. BASED ON THIS REASONING, THE SRI LANKAN TEA EXPERTS FEEL VERY CONFIDENT ABOUT THE LIKELIHOOD OF SUSTAINING HIGHER FOREIGN EXCHANGE EARNINGS FROM TEA DURING THE NEXT FEW YEARS. AFTER SEVERAL CONSECUTIVE YEARS OF DISAPPOINTING PERFORMANCE, THE TEA EXPORT VOLUME INCREASED TO ABOUT 203 MILLION KGS IN 1984, A 21 PERCENT INCREASE OVER 1983. AN ANNUAL INCREASE OF BETWEEN 5 PERCENT TO 8 PERCENT IS PROJECTED, SUBJECT TO FAVORABLE WEATHER CONDITIONS, DURING THE NEXT FIVE YEARS DUE TO ON GOING AND PLANNED EFFORTS TO REVITALIZE THE TEA INDUSTRY.

7. GIVEN THIS PREDICTION OF SUSTAINING HIGHER EXPORT EARNINGS FROM TEA, THE BALANCE OF PAYMENTS OUTLOOK SHOULD REMAIN RELATIVELY FAVORABLE DURING THE MEDIUM-TERM. THE MEDIUM-TERM BALANCE OF PAYMENTS OUTLOOK DETERMINES THE POSSIBLE LONGER TERM DEVELOPMENTS IN THE BALANCE OF

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PAYMENTS. IF THE MEDIUM-TERM BALANCE OF PAYMENTS REMAIN FAVORABLE, THE GSL WILL BE IN A POSITION TO (A) RETIRE MOST OF ITS SHORT-TERM LOANS AND CREDITS DURING THE NEXT FEW YEARS AND (B) MEET THE COUNTRY'S FOREIGN EXCHANGE REQUIREMENTS WITHOUT SECURING HIGH COST COMMERCIAL BORROWINGS. THE MANAGEMENT OF SHORT-TERM REPAYMENT OBLIGATIONS TOGETHER WITH ONLY LIMITED DEPENDENCY ON SHORT TERM BORROWINGS DURING THE NEXT FEW YEARS SHOULD LEAD TO A SIGNIFICANT IMPROVEMENT BEYOND THE 1990-1992 PERIOD.

CONCESSIONAL LOANS, WITH THE CONSEQUENCE THAT THE PRESENT DEBT SERVICE RATIO AT ABOUT 8.7 PERCENT OF EXPORTS OF GOODS AND NON-FACTOR SERVICES AND 2.6 PERCENT OF GDP, IS RELATIVELY LOW."

8. AS NOTED BY THE IMF IN REF B SRI LANKA'S DEBT STRUCTURE HAS UNDERGONE SUBSTANTIAL CHANGES, PARTICULARLY AFTER 1979 DUE TO INCREASED SHORT-TERM BORROWINGS. WHILE THE SHARE OF CONCESSIONAL BORROWINGS DECLINED FROM 73 PERCENT IN 1979 TO 53 PERCENT IN 1983, DESPITE NEARLY DOUBLING IN ABSOLUTE TERMS FROM SDR 304 MILLION TO SDR 1,548 MILLION, THE SHARE OF COMMERCIAL BORROWINGS INCREASED FROM 6 PERCENT IN 1979 TO 33 PERCENT IN 1983 DUE TO A 13 FOLD GROWTH FROM SDR 66 MILLION TO SDR 924 MILLION. THE RESIDUAL, WHICH CONSISTS OF THE IMF CREDITS AND STAND-BY FACILITIES INCREASED FROM SDR 231 MILLION IN 1979 TO SDR 336 MILLION IN 1983, BUT DECLINED AS A SHARE FROM 21 PERCENT TO 12 PERCENT DURING THE SAME PERIOD. AS THE WORLD BANK REPORT POINTS OUT (REF D, P.64) THE MORE SIGNIFICANT FACTOR IN THE INCREASE IN DEBT OBLIGATIONS HAS BEEN THE CHANGE IN THE COMPOSITION OF THE TOTAL DEBT AS A RESULT OF SRI LANKA'S DECISION TO BEGIN COMMERCIAL BORROWINGS ON A SIGNIFICANT SCALE. THE INCREASED COMMERCIAL BORROWING CONSISTING MOSTLY OF SHORT-TERM CREDITS WITH MATURITY OF LESS THAN ONE YEAR, HAS ALSO LED TO THE DETERIORATION OF THE MATURITY STRUCTURE WITH THE SHARE OF SHORT-TERM DEBT INCREASING FROM 1 PERCENT TO ALMOST 11 PERCENT BETWEEN 1979 AND 1983 (REF B, P.56). FYI, THE MATURITY ON A HG LOAN IS USUALLY 30 YEARS. END FYI.

11. ACCORDING TO SENIOR OFFICIALS OF THE CENTRAL BANK AND THE MINISTRY OF FINANCE AND PLANNING, THE GSL IS VERY CONSCIOUS OF THE IMPLICATIONS OF COMMERCIAL BORROWINGS ON THE BALANCE OF PAYMENTS AND PARTICULARLY ON THE DEBT SERVICE RATIO. THEY BELIEVE THAT, IF TEA EXPORT EARNINGS REMAIN FAVORABLE, THE SRI LANKAN ECONOMY CAN COPE WITH THE FOREIGN EXCHANGE REQUIREMENTS WITHOUT COMMERCIAL BORROWINGS AT ANY SIGNIFICANT SCALE. MOREOVER, THE GSL HAS ESTABLISHED A DEBT MANAGEMENT DIVISION, WITHIN THE MINISTRY OF FINANCE AND PLANNING, TO MONITOR, CONTROL AND SCRUTINIZE COMMERCIAL EXTERNAL BORROWINGS BY THE PRIVATE SECTOR AND PUBLIC SECTOR CORPORATIONS.

12. THE ASIA BUREAU MEMO STATES IN SECTION 5 THAT SRI LANKA ENTERED INTO A STAND-BY AGREEMENT WITH THE IMF IN SEPTEMBER 1983 BUT SOON FELL OUT OF COMPLIANCE, IN PART DUE TO THE ETHNIC DISTURBANCE. OUR UNDERSTANDING IS THAT THE GSL WAS NOT WILLING TO IMPOSE ADDITIONAL REFORM MEASURES, PARTICULARLY A RUPEE DEVALUATION, DUE TO IMPROVED INTERNATIONAL MARKET FOR TEA EXPORTS AND AS A RESULT THE STAND-BY AGREEMENT CEASED AFTER THE RELEASE OF THE FIRST SDR 50 MILLION OF THE SDR 100 MILLION AGREEMENT. IN FACT, SRI LANKA SECURED MORE CONCESSIONAL ASSISTANCE THAN ANTICIPATED FROM THE AID GROUP IN JULY 1984, DESPITE THE ABSENCE OF A STAND-BY AGREEMENT WITH THE IMF.

9. ONE OF THE MAJOR IMPLICATIONS OF COMMERCIAL BORROWING IS THE HIGH RATE OF INTEREST AND ITS INFLUENCE ON THE DEBT SERVICE RATES. AS THE WORLD BANK POINTS OUT (REF C, P.17) A DOLLAR 100 MILLION BORROWING ON COMMERCIAL TERMS DURING 1983 (ASSUMING 10 PERCENT INTEREST, 3 YEARS GRACE AND 10 YEARS MATURITY) WOULD ADD ABOUT 1.3 PERCENTAGE POINTS TO THE DEBT SERVICE RATIO BY 1986. EXAMINING THE COMPOSITION OF DEBT SERVICE RATIOS IN THE PAST (REF B, TABLE 25), LEADS TO THE CONCLUSION THAT INTEREST PAYMENTS IS THE MAIN FACTOR UNDERLYING THE GROWING DEBT SERVICE COMMITMENTS. FOR EXAMPLE, THE 1979 DEBT SERVICE RATIO WAS THE SUM OF 8.3 PERCENT AMORTIZATION AND 4.1 PERCENT INTEREST WHILE THE RESPECTIVE FIGURES FOR 1983 WERE 9.6 PERCENT AND 12.4 PERCENT. THIS INCREASE IN THE SHARE OF INTEREST PAYMENTS IN THE OVERALL DEBT SERVICE RATIO IS LARGELY AN OUTCOME OF COMMERCIAL BORROWINGS AT MARKET INTEREST RATES. THE IMPORTANCE OF COMMERCIAL BORROWINGS ON THE DEBT SERVICE RATIO CAN BE EMPHASIZED FURTHER BY EXAMINING THE DECLINE IN DEBT SERVICE RATIO FROM 23 PERCENT IN 1973 TO 12.1 PERCENT IN 1979 AS A RESULT OF REPAYMENTS OF COMMERCIAL BORROWINGS AND A REDUCTION IN ADDITIONAL COMMERCIAL BORROWINGS DURING THAT PERIOD.

13. THE GSL HAS NOT BEEN IGNORING THE NEED FOR STRUCTURAL REFORM. RECENT REFORM ACTIONS TAKEN BY THE GSL INCLUDE: (1) THE REVISION OF TARIFF POLICY WITH THE AIM OF ELIMINATING THE BIAS AGAINST EXPORTS NOTED BY THE IMF AND REDUCING THE RANGE OF RATES; (2) REFORMS OF PUBLIC ENTERPRISES INCLUDING THE INTRODUCTION OF SOME MANAGEMENT PERFORMANCE INCENTIVES AND THE APPOINTMENT OF A NEW MINISTER OF INDUSTRY AND NEW DIRECTORS FOR STATE ENTERPRISES WHO SHARE A MORE COMPETITION AND EFFICIENCY-ORIENTED PERSPECTIVE; (3) THE APPLICATION OF SURPLUS TEA EXPORT EARNINGS TO THE REPAYMENT OF SHORT-TERM DEBT; (4) IMPLEMENTATION OF THE MEDIUM TERM INVESTMENT PROGRAM TO REHABILITATE TREE CROP PLANTATIONS; (5) IMPLEMENTATION OF A MORE RATIONAL ENERGY POLICY WHICH, WITH THE COMPLETION OF THE FIRST PHASES OF THE MAHAVELI PROJECT, WILL REDUCE RELIANCE ON OIL IMPORTS AND, AS A CONSEQUENCE OF MARKET PRICING, WILL PROMOTE CONSERVATION; AND (6) THE INTRODUCTION OF BUDGET REFORMS TO INCREASE CONTROLS ON EXPENDITURES AND RATIONALIZE PUBLIC INVESTMENTS. IN ADDITION, THE RATE OF INFLATION IS FALLING AND A REAL GDP GROWTH RATE OF 3 TO 6 PERCENT IS PROJECTED FOR 1985.

10. AS THE ABOVE DEMONSTRATES, COMMERCIAL BORROWINGS IS PERHAPS THE SOLE CONTRIBUTOR TO THE RECENT DETERIORATION IN THE EXTERNAL DEBT SITUATION. IF THE GSL CAN MONITOR COMMERCIAL BORROWINGS WITH A VIEW TO DRASTICALLY REDUCE ITS DEPENDENCY ON SUCH BORROWINGS, THE EXTERNAL DEBT SITUATION WILL SIGNIFICANTLY IMPROVE ONCE THE CURRENT SHORT-TERM OBLIGATIONS ARE MET BY 1991. THIS WAS PRECISELY THE POINT THAT THE WORLD BANK MADE (REF D, P.94) WHEN IT STATED THAT "WHILE THIS (EXTERNAL DEBT) IS RELATIVELY HIGH COMPARED TO MOST DEVELOPING COUNTRIES, OVER 80 PERCENT OF THE DEBT COMPRISES LONG-TERM

14. CERTAIN REFORMS SOUGHT BY THE IMF HAVE NOT BEEN IMPLEMENTED BY THE GSL. MOST IMPORTANTLY, TAX REFORMS NEEDED TO MAINTAIN PUBLIC SECTOR REVENUES AND THE MANAGEMENT OF EXCHANGE RATES IN A MANNER CALCULATED TO ENCOURAGE INVESTMENT IN NON-TRADITIONAL EXPORT PRODUCTION HAVE NOT BEEN THE SUBJECTS OF MUCH GSL ENTHUSIASM, ALTHOUGH A 5 PERCENT DEVALUATION IN 1983 AND A SUBSEQUENT MANAGED FLOAT HAVE RESULTED IN SOME DEPRECIATION OF THE RUPEE AGAINST THE DOLLAR. APPRECIATION AGAINST THE CURRENCY OF SRI LANKA'S MAIN EUROPEAN TRADING PARTNERS CONTINUES, HOWEVER. GSL OFFICIALS DEFEND THESE POLICIES ON THE GROUNDS THAT CURRENT EXCHANGE RATES DO NOT OVER-VALUE THE RUPEE AND THAT THE EXPORT-INCENTIVE VALUE OF DEVALUATION MUST BE BALANCED AGAINST OTHER CONSIDERATIONS INCLUDING THE COST OF NECESSARY IMPORTS AND EXTERNAL LOAN REPAYMENTS. SINCE TEA EARNINGS ARE CURRENTLY HIGH, SUCH OTHER FACTORS WEIGH HEAVILY.

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15. IT IS ALSO WORTH NOTING THAT:
- (A) ALTHOUGH EXPORT EARNINGS FROM RUBBER HAVE STAGNATED
 - AND COCONUT EARNINGS HAVE DECLINED, REDUCTIONS IN THE
 - COST OF IMPORTED COMMODITIES INCLUDING PETROLEUM,
 - WHEAT AND SUGAR HAVE COMPENSATED;
 - (B) TOURISM HAS NOT RECOVERED FROM THE BAD PUBLICITY
 - ATTENDING SRI LANKA'S COMMUNAL PROBLEMS AND WOULD
 - PROBABLY RECOVER ONLY GRADUALLY EVEN IF THESE
 - DIFFICULTIES COULD BE IMMEDIATELY ENDED;
 - (C) REMITTANCES FROM EXPATRIATE WORKERS CONTINUE TO
 - INCREASE SLOWLY IN SPITE OF REDUCTIONS IN THE DEVELOP-
 - MENT PROGRAMS OF GULF COUNTRIES. NO DECLINES IN SUCH
 - EARNINGS ARE ANTICIPATED IN THE NEAR FUTURE ALTHOUGH
 - GROWTH IS LIKELY TO BE SLOW;
 - (D) AN IMPORTANT EFFECT OF THE MAHAVELI PROJECT, AMONG
 - OTHER EFFORTS, HAS BEEN TO BRING SRI LANKA NEAR TO
 - SELF-SUFFICIENCY IN RICE PRODUCTION. ALTHOUGH
 - POSSIBLE FUTURE RICE SURPLUSES ARE UNLIKELY TO BE
 - EXPORTABLE BECAUSE OF QUALITY PROBLEMS, THERE MAY BE
 - SOME ROOM TO DISPLACE WHEAT IMPORTS, DEPENDING UPON
 - PRICING POLICIES.
16. THE LARGEST UNKNOWN IN ANY PROJECTION OF SRI LANKA'S ECONOMIC FUTURE IS THE ETHNIC SITUATION. THERE HAS BEEN VERY LITTLE PROGRESS TOWARDS RESOLUTION OF THE ISSUES AND THE SITUATION WILL CONTINUE TO BE UNSTABLE. ALTHOUGH WE DO NOT SEE THE ETHNIC PROBLEMS HAVING ANY MAJOR NEW IMPACT ON THE BALANCE OF PAYMENTS, A SPREAD OF THE COMMUNAL VIOLENCE TO THE TEA GROWING AREAS COULD HAVE SERIOUS REPERCUSSIONS ON TEA EXPORT EARNINGS. AT THIS POINT IN TIME, WE DO NOT VIEW THIS AS LIKELY.
17. THERE IS NO MEANINGFUL WAY TO PREDICT THE DEBT-SERVICE CAPACITY OF ANY DEVELOPING COUNTRY OVER THE TYPICALLY LONG TERMS OF HQ GUARANTEES. WITH RESPECT TO SRI LANKA, WHAT CAN BE SAID IS THAT BOTH THE CURRENT SITUATION AND THE FORESEEABLE FUTURE ARE CONSIDERABLY HEALTHIER THAN ANTICIPATED BY THE IMF. ALTHOUGH THE GSL HAS NOT DONE ALL THAT MIGHT BE DESIRABLE FROM A PURELY MACRO-ECONOMIC STAND POINT IN THE WAY OF TAX AND EXCHANGE RATE REFORMS, THEY HAVE TAKEN A NUMBER OF POLITICAL AND ECONOMIC STEPS TO MAKE SUCH REFORMS MORE PALATABLE AND THEREFORE MORE LIKELY. IN ANY CASE, THERE APPEARS TO BE NO PERSUASIVE REASON TO RESTRICT SRI LANKA FROM FURTHER HQ BORROWING IN AMOUNTS NOW CONTEMPLATED.
18. MISSION WILL POUCH AVAILABLE TEA MARKET REPORTS TO ASIA/DP FOR YOUR REVIEW. REED

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International
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SRI LANKA - KEY ECONOMIC INDICATORS

Money Values in millions of rupees except where noted

Exchange Rates -
SL Rupees per U.S. Dollar

	1982	1983
Year End	21.32	25.00
Annual Avg.	20.85	23.62

	1982	1983	% Change	1984 Proj.
<u>PRODUCTION AND INVESTMENT</u>				
GDP at Current Factor Cost Prices	91,643	111,335	21.5	140,839
GNP at Current Factor Cost Prices	89,609	108,171	20.7	135,755
Per Capita GNP at Current Prices (Rs.)	5,900	7,017	18.9	8,736
GDP at Constant (1970) Prices	21,756	22,824	4.9	24,079
Real GDP Growth Rate (%)	5.1	4.9	-	5.5
Gross Fixed Capital Formation	30,360	35,246	16.1	37,523
Foreign Investment Approvals	3,032	5,059	66.8	4,000
<u>LABOR, EMPLOYMENT, AND WAGES</u>				
Resident Population (Millions) 1/	15.2	15.5	2.0	15.8
Labor Force (Millions) 1/	6.0	6.1	2.2	6.2
Unemployment (%) 1/	15.0	17.0	-	18.0
Nominal Minimum Wage Rates (% Growth)				
-- Agriculture	18	10	-	20
-- Industry and Commerce	7	1	-	10
-- Government	29	15	-	15
<u>MONEY AND PRICES</u>				
M-2 Growth Rate (%)	25	22	-	25
Avg. Cost of Living Index (% Growth)	11	14	-	21
Wholesale Price Index (% Growth)	6	25	-	15
<u>GOVERNMENT FINANCE</u>				
Expenditures	37,900	46,772	23	48,442
-- of which Mahaweli Investment	(7,313)	(6,952)	-5	(6,017)
Revenue	17,809	25,210	42	30,770
Budget Deficit	20,091	21,562	7	17,672
<u>BALANCE OF PAYMENTS (\$ MILLION)</u>				
Exports, f.o.b.	1,029	1,062	3	1,324
-- U.S. Share	143	185	29	241
Imports, c.i.f.	2,012	1,929	-4	2,058
-- U.S. Share	111	114	3	117
Trade Balance	-975	-859	12	-734
Current Account Balance 2/	-731	-647	-12	-526
Gross Tourist Receipts	128	101	-22	131
Gross Private Remittances	289	290	0.3	300
Foreign Aid Disbursements	428	467	9	408
-- of which U.S.	59	73	24	93
Gross External Assets (Year End)	532	543	2	605
External Debt (Year End)	2,400	2,783	16	3,000
Debt Service Ratio (%) 3/	19	22	-	21
Terms of Trade (1978-100)	38	44	-	48

Main Imports from U.S. (1983): Wheat (\$36 Million), Aircraft & Parts (\$24 Million)
Machinery & Equipment (\$6 Million)

Notes: 1/ Estimates; 2/ Includes Public Transfers; 3/ Includes IMF Repurchases

Source: Central Bank Annual Report, 1983; Public Investment 1984-1988; Customs Data;
Embassy Estimates

SUMMARY

One year after a spasm of communal violence shattered Sri Lanka's stability, the search for a long-term solution to the Sinhalese-Tamil ethnic conflict continues to dominate the political scene and adversely impacts the environment for foreign investment. Economic growth, which in 1983 was affected by the disturbances and a prolonged drought, is projected to return again to pre-violence levels of 5-6 percent. The country's ambitious capital development program continues to strain the national budget, but a more austere fiscal policy has reduced the relative size of the deficit. Nevertheless, as the demand for credit skyrocketed in the wake of the July 1983 violence, inflation surged back and continues to be a problem. Although high tea prices have narrowed the trade and current account deficits, they are only a temporary palliative for the external sector's structural imbalance. Short-term indebtedness has risen, and the debt-service ratio is now at 21 percent. The most important challenges in the years ahead will be stimulation of the private industrial sector, expansion of exports, and repayment of the mounting external debt.

Relations between Sri Lanka and the United States are very good. There is scope for expansion of trade within the constraints of Sri Lanka's small domestic market. The most promising areas for investment are in resource-based industries, including agrobusiness, rubber products, and minerals processing.

I. CURRENT ECONOMIC SITUATION AND TRENDS

POLITICAL SETTING IS DOMINATED BY ETHNIC CONFLICT

Hopes that the reelection of President J.R. Jayewardene in late 1982 would set the stage for a new period of sustained political stability and economic growth were shattered in June and July 1983 by the outbreak of Sri Lanka's worst communal riots since independence. Over 400 people are acknowledged to have been killed, and property damages, both residential and industrial, reached an estimated \$150 million.

Since then, the political scene has been dominated by efforts to reach a long-term accommodation and reconciliation of the interests of the Sinhalese majority and the Tamil minority communities. President Jayewardene convened an All-Party Conference (APC) in January to provide a forum in which all communal grievances could be discussed and dealt with rationally and peacefully. Unfortunately, by mid-year reconciliation was no closer to realization. In fact, the Sri Lanka Freedom Party -- the major opposition -- withdrew from the APC, and Tamil militants resumed terrorist activity in the north, culminating in the May kidnapping of an American couple working in Jaffna on an A.I.D. project. The Americans were subsequently released unharmed, but the security situation in the north remains highly unsettled.

The July disturbances also took their toll on the economy. The manufacturing sector suffered losses of around 150 factories, including textiles, garments, coconut oil and products, processed food, and PVC pipes and fittings. Trade was disrupted by the destruction of many wholesale and retail outlets, and rail, road and port transport services were interrupted. Road and telecommunications maintenance suffered because of personnel losses, and construction activity, especially in public sector investment projects, experienced delays. The biggest casualty in services was the tourist trade, which has not fully recovered even a year later. Longer-term consequences which still cannot be fully appraised include a "brain drain" of indigenous talent emigrating abroad, capital flight, and the deleterious impact on investor confidence.

PROSPECTS FOR ECONOMIC GROWTH

The over-6 percent growth rates of the late 70's have slowed in recent years as structural imbalances surfaced. The combined effects of a prolonged drought and the July disturbances brought real GDP growth in 1983 down to 4.9 percent, and real GNP to 4.0 percent, the lowest rate since 1977.

In its planning document Public Investment 1984-1988, the Sri Lankan Government projects a real GDP growth rate of about 5.5 percent per annum over the five-year period. This assumes, somewhat problematically, a sharp and sustained recovery in both construction and manufacturing activity. The need to restrain budgetary expenditures has slowed the 1984-1988 capital investment program, which will certainly affect the construction industry. Efforts to revitalize the manufacturing sector have to date not met with great success, perhaps because of the continued domination of state-owned corporations. The following table shows official growth targets for 1984:

	<u>Percent of Real GDP in 1983</u>	<u>Real Growth in 1983</u>	<u>Projected Real Growth in 1984</u>
Agriculture, Forestry, Fishing	24	5.0	4.0
-- Tea	(1.6)	(4.5)	(3.7)
-- Rubber	(0.9)	(8.8)	(0.3)
-- Coconut	(2.3)	(7.9)	(1.8)
-- Paddy	(6.4)	(14.7)	(2.6)
Mining and Quarrying	4	7.8	7.4
Manufacturing	13	0.8	6.2
Construction	4	1.0	8.0
Services	<u>55</u>	<u>6.6</u>	<u>5.6</u>
Total Real GDP	100	4.9	5.5

AGRICULTURE: Agriculture has traditionally been Sri Lanka's most productive sector, accounting for half the island's employment and more than a quarter of GDP. Over the past 20 years, however, the three major plantation crops -- tea, rubber, and coconuts -- have suffered from neglect. The declining yields of recent years can be attributed to a variety of factors, including low producer margins, insufficient use of fertilizer, and poor management of the estates since the sweeping nationalization measures of 1972. Because of the present and potential contribution these three crops make to exports, the plantation sector has become a new priority of Sri Lanka's public investment plan. The Medium Term Investment Program for state plantations extends from 1985-1989 and will cost an estimated 4 billion rupees.

Although by mid-1984 world prices for Sri Lankan tea are declining somewhat since India removed its ban on exports of CTC tea, Sri Lanka still expects a dramatic increase in tea export earnings vis-a-vis 1983 because of the fortuitous combination of strong prices and production gains due to favorable weather conditions. Significant results from the replanting and rehabilitation activities will not be evident for at least five years.

In the meantime, the vitality of the agricultural sector must come from rice paddy and other food crops. The virtual explosion in paddy output since 1977 has been one of the great success stories of the current Government. Production of paddy almost doubled over seven years, from 60 million bushels in 1976 to 119 million bushels in 1983. During the same period, average yields rose from 44 to 70 bushels per acre.

Although the floods in the first quarter of 1984 reduced the quantity and quality of the Maha harvest, paddy production could still reach the record harvest realized last year if weather conditions favor the Yala crop. Most studies agree that Sri Lanka is likely to achieve sustainable levels of rice self-sufficiency within the next five years.

Other crops which show export potential are groundnuts, soya beans, greengram, blackgram, and fruits and vegetables.

INDUSTRY: The outlook for industry is less auspicious. Despite recent efforts to promote private sector development, two-thirds of industrial output still comes from the relatively inefficient state corporations. Manufacturing output in 1983 increased only marginally, by 0.8 percent, as a 26 percent increase in private sector production offset a 15 percent decline in state-owned industries.

Industry's poor 1983 performance can be attributed in part to a two-month shutdown of the petroleum refinery early in the year -- petrochemical production has a heavy weight in public sector output -- and in part to the July troubles, during which around 150 industrial establishments were damaged or destroyed. Furthermore, two large public enterprises, the nylon 6 project and the

urea plant, were closed during the year because they had become unprofitable. On the other hand, the dynamic garment sector in the Investment Promotion Zone registered a 34 percent increase in production. Output of food, beverages and tobacco rose by 11 percent, due undoubtedly to strong performances of the Prima Flour Mill in Trincomalee and the Ceylon Tobacco Company.

Barring unforeseen setbacks, industrial production should improve in 1984, after last year's dismal performance. Most of the productive units damaged last July have already been rehabilitated; others which were unproductive or belonged to subsectors with excess capacity have been written off. With the improvement in weather conditions for tea, rubber, and coconuts, export processing industries should be able to increase production. Although growth in the textile industry may be somewhat lower in 1984 due to quotas set in bilateral textile agreements with the U.S. and European countries, this sector should continue its steady expansion.

The 1984-1988 Public Investment Plan accords the primary role in industrial development to the private sector. Generally, however, private sector industrial development has not yet caught fire. This may be a result of the overbearing weight and relative inefficiency of public corporations, and to a bias in tax, tariff and exchange rate incentives against industry and in favor of tourism, trade, and real estate. The Government is aware of the need for further measures to improve the climate for private industry. The Plan calls for a conscious reformulation of policy instruments, institutional arrangements, and enhancement of efficiency in both public and private sectors.

Perhaps the most promising area is further development of resource-based industry which would add value to Sri Lanka's agricultural and mineral production. Three firms have signed joint venture agreements to invest in new import-substituting sugar projects. When these come on stream by the late 1980's along with the Sevanagala sugar project, estimated domestic production should cover about two-fifths of demand. The Asian Development Bank is sponsoring a \$17 million aquaculture project, and a feasibility study for a U.S.-Sri Lankan joint venture in dairy development is under way.

SERVICES: Despite the 17 percent drop in tourist arrivals and the disruption in trade caused by last July's communal violence, the services sector was largely responsible for the 4.9 percent growth in 1983. Contributing 55 percent to GDP, services registered a 6.6 percent growth rate last year. Trade and transport showed the strongest expansion.

The tourism sector has been a major growth area since 1977 for both investment and employment, and has become an important source of foreign exchange. However, the outlook in 1984 is cloudy. As

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a result of the Western European recession, exacerbated by adverse publicity from the July disturbances, tourist arrivals in mid-1984 are still lagging behind last year. The occupancy rates in many existing facilities, particularly in the north and east, are uncomfortably low. Several international hotel chains -- the Taj, Ramada, Meridian, and Hilton -- are building new hotels in Colombo which are in various stages of construction. When all are completed the capital should have more than enough beds for many years to come. The Government has decided that the needs of the tourist industry have been largely met, and thus as a general policy is not approving applications for new hotels.

FREE TRADE ZONE SEEKS TO DIVERSIFY

After just six years in existence, the Investment Promotion Zone -- popularly known as the Free Trade Zone -- is easily the most dynamic center of modern industrial activity in Sri Lanka. It must be considered at least a qualified success. At year-end 1983, there were 66 factories in commercial production, employing close to 29,000 workers, and representing a total equity investment of about \$80 million at current exchange rates. According to figures compiled by the Greater Colombo Economic Commission (GCEC), gross export earnings increased geometrically during the full five years of operation, amounting to about \$96 million in 1983.

One source of concern in the Zone has been the preponderance of garment factories, which accounted for half of all the factories in commercial production, 67 percent of employed workers, and 80 percent of export earnings by the end of 1983. As domestically-produced fabric does not yet meet international standards, virtually all of the raw material for Free Trade Zone garments must come from abroad, which means the local value-added amounts to only about 25 percent of the finished product. GCEC management is actively seeking to diversify the manufacturing base in the IPZ, and in 1983 only one out of 13 new projects approved was in the textile sector. The others were in agriculture, basic metals, and other industries. Sri Lanka has also become less attractive for textiles because of the difficulty in obtaining quotas for U.S. and European markets. Thus companies interested in investing in the garment industry now prefer to purchase an existing facility with its quota allocation.

The GCEC began work on its second industrial zone at Biyagama in 1983. The first stage will cover 112 acres, providing for about 20 industrial plots together with infrastructural facilities.

In the near term, the benefit from the Free Trade Zone has come in the form of foreign capital and the creation of new employment opportunities. However, the ultimate payoff -- transfer of technology, work habits and managerial know-how, and links with feeder industries outside the Zone -- is a gradual process which is unlikely to come to fruition for several more years.

MAHAWELI PROGRAM CELEBRATES COMMISSIONING OF VICTORIA DAM

The Accelerated Mahaweli River hydroelectric/irrigation/resettlement program, an enormously complex and expensive undertaking for a country of Sri Lanka's size, is the centerpiece of the national development program for the 1980s. Originally conceived as a 30-year undertaking, the program involves the construction of several dams in the mountainous interior of the country and a network of downstream irrigation canals extending in a wide diagonal swath northeast to the Trincomalee region. The dams will provide badly-needed hydroelectric power, while the irrigation works open up dryland areas to intensive agriculture and resettlement of landless farmers. Under the accelerated program, it is expected that the bulk of the construction work on the large dams will be completed during 1980-86, although downstream development projects will continue for many years.

Up to the end of 1983, foreign aid financed most of the Rs. 20 billion expenditure incurred for the Mahaweli program. Major donors include Canada (Maduru Oya), the United Kingdom (Victoria), Sweden (Kotmale), West Germany (Randenigala), and the United States (downstream System B and parts of System H). The Mahaweli continues as the biggest item in the Public Investment Program through 1986, and an additional Rs. 21.2 billion is earmarked for the program during 1984-88. Following is a thumbnail sketch of the major components of the program:

(Rupees Million)				
<u>Headworks</u>	<u>Generating Capacity</u>	<u>Construction Period</u>	<u>Expenditure Through 1983</u>	<u>Projected Expenditure 1984-1988</u>
Maduru Oya	-	1980-83	2,507	-
Victoria	210 MW	1980-84	5,107	2,538
Kotmale	132 MW	1980-85	4,742	3,024
Randenigala	130 MW	1982-87	1,045	2,919
Rantambe	40 MW	1986-89	0	-
<u>Downstream Irrigation</u>	<u>Acreage to be Settled</u>			
System B	120,000	1982-86	1,258	8,237
System C	60,000	1980-86	1,217	3,284
System H	106,000	1978-82	2,099	-
System G	1,300	1982-87	8	253

In 1983, the major part of the headworks of Victoria -- the largest power project -- was completed, and power generation is scheduled to commence in July. Maduru Oya, one of the major irrigation reservoirs, was also finished. Work on the other projects is proceeding well, although heavy rains during the first part of 1984 caused some delays. By the end of 1983, a total of 215,000 acres had benefitted from Mahaweli irrigation.

ENERGY OUTLOOK

With the rising level of economic activity since 1977, the demand for energy in Sri Lanka is on a steep upward curve. Up to 1983, demand for electricity and petroleum products expanded at average annual rates of 12 and 10 percent, respectively.

The pattern of energy consumption in 1982 was estimated as follows:

(000 tons of oil equivalent)

	<u>Petroleum</u>	<u>Electricity (Hydro)</u>	<u>Fuelwood</u>	<u>Percentage</u>
Industry/Commercial	349	69	586	28
Transport	658	-	-	18
Households	185	40	1,684	53
Other	5	36	-	1
<hr/>				
Percentage	33	4	63	100

The high cost of imported oil has placed a severe strain on Sri Lanka's balance of payments. Although oil prices on the world market fell in 1983, the severe drought restricted Sri Lanka's hydrogenerating capacity. Thus domestic consumption of imported oil products, especially heavy diesel used in thermal power plants, increased.

The Public Investment Plan gives high priority to investment in the power sector to meet the increasing demand for energy. Total generating capacity is projected to expand from 511 MW in 1983 to 1,353 MW by 1990. Of this, 1,013 MW will be hydro and 340 MW thermal. Total hydropower potential is estimated at about 2,000 MW. The Asian Development Bank is financing the feasibility study for a proposed coal-fired plant to come on stream in the early 1990s. There have been some efforts at oil exploration -- both offshore and onshore -- but no discoveries or indications of significant reserves have surfaced to date.

FISCAL POLICY TIGHTER

One of the most serious problems facing the Government since the introduction of the economic revitalization program in 1977 is the chronic and expanding budget deficit, induced in part by the ambitious capital development program. The deficit rose, almost steadily, from Rs. 3.1 billion in 1977 to Rs. 21.6 billion in 1983. The problem is well illustrated in the following table.

<u>Budget</u>	(Rupees Million)		
	<u>1983</u>	<u>Projected 1984</u>	<u>1985</u>
GDP at current factor cost	111,335	125,809	145,938
Budget Deficit	21,562	17,672	17,513
-- as % of GDP	19	14	12
Budget Expenditures	46,772	48,442	51,210
-- as % of GDP	42	38	35
Mahaweli Capital Expenditure	6,952	6,017	6,845
-- as % of Budget	15	12	13
-- as % of GDP	6	5	5

Source: Ministry of Finance and Planning,
Embassy estimates

During 1983, although the deficit continued to rise, overall fiscal performance improved. The July disturbances affected revenue collection from turnover and income taxes, but this was offset by the tax and tariff increases enacted earlier in the year and a windfall from the upturn in tea prices. Total revenues thus rose by 42 percent, while expenditures went up only 18 percent, largely the result of a slowdown in capital development projects. The financing gap was lowered to 0.6 percent of GDP, considerably reducing the budget's inflationary impact on the economy.

The policy of greater fiscal discipline is expected to continue in 1984. Revenues will again benefit greatly from the fortuitous strength of commodity prices, while the continuing moratorium on new projects slows the growth in capital expenditures. Budget expenditures are projected at 38 percent of GDP, with the deficit equal to 14 percent. The Government hopes to cover 75 percent of the deficit by foreign financing and 25 percent with domestic savings, obviating the need for any inflationary domestic bank financing this year.

A very worrisome consequence of the chronic budget deficit is the growing cost of debt servicing. In 1984, interest and amortization payments will swallow 21 percent of expenditures, by far the single largest item. Growth in this ratio shows no sign of abating.

MONETARY EXPANSION FUELS INFLATION

Monetary aggregates have undergone a similar explosion -- the broad money supply rose at an average of 28 percent from 1978-83 -- because of both public and private sector needs for credit to finance investment. In 1983, the slowdown in capital expenditures and greater fiscal austerity greatly reduced government borrowing,

but private sector demand mushroomed when interest rates were lowered, the currency devalued and the prices of many staples increased early in the year. The July disturbances again increased the need for private sector credit to cover losses and reconstruction. Although the Central Bank raised reserve requirements for commercial banks last November and recently reimposed credit ceilings, monetary aggregates are still rising at an annual rate of over 25 percent. The boom in tea prices, while having a salutary effect on the balance of payments, is aggravating the problem of excess liquidity.

After a marked deceleration in election year 1982, inflation has again jumped to uncomfortably high levels. Although the average CPI rise was 14 percent in 1983, the December-to-December increase reached 21 percent. Exacerbated by the rapid monetary expansion and higher food prices stemming from adverse weather conditions, rapid inflation continues to plague Sri Lanka in 1984, and the Finance Minister acknowledges it is still at the 20 percent level. Pressures for wage increases are also growing. Since the poorly-paid tea estate workers gained substantial salary raises by staging a 10-day strike in March, it is not unlikely that workers in other sectors may begin to push their demands.

BALANCE OF PAYMENTS GAINS FROM TEA WINDFALL

Sri Lanka's primary economic concern over the long term is the structural imbalance in its external payments. Fueled by the Jayewardene Government's liberal, rapid growth policies and high oil prices, imports have more than doubled since 1978. Exports, which are heavily biased towards agricultural products, rose by only 50 percent over the same period. The import bill between 1978-83 totaled 41 percent of GDP.

Both tourism and remittances from the circa 150,000 emigrants working in the Middle East have also become important sources of foreign exchange in recent years, the latter second only to tea.

The structure of Sri Lanka's foreign trade in 1983 is shown in the following table:

(Rupees Million)			
<u>Exports</u>		<u>Imports</u>	
Tea	8,295	Pet oleum Products	10,040
Textiles/Garments	4,651	Transport Equipment	4,502
Petroleum Products	3,017	Machinery & Equipment	4,070
Rubber	2,856	Textiles and Textile	
Coconuts	1,921	Materials	3,814
Minor Agricultural		Sugar	1,677
Products	1,184	Wheat	1,623
Gems and Jewelry	980	Rice	918
Other	<u>1,939</u>	Other	<u>18,909</u>
Total	24,843		45,553

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The 1983 trade and current account balances showed some improvement vis-a-vis 1982, largely a result of improved prices for plantation crops and a decline in imports which became more expensive in rupee terms. A further improvement is forecast for 1984: tea prices are at near-record levels; favorable weather conditions presage higher production for tree crops; and the demand for petroleum products will be eased by increased availability of hydroelectric power. Nevertheless, the projected 1984 current account deficit of \$734 million is still a sizable amount to be covered primarily by foreign loans and grants. This points up the fact that the fundamental imbalance between Sri Lanka's foreign earnings and payments persists, and should commodity prices tumble in the near term, a balance of payments crisis could ensue.

EXTERNAL DEBT: Sri Lanka has been very fortunate in obtaining extremely advantageous terms for its foreign borrowing, most of which has been in the form of concessional loans and grants from Western aid donors. However, in recent years public corporations such as Air Lanka and the Ceylon Shipping Corporation, and private firms with FCBU's (Foreign Currency Banking Units) have contributed to both the external debt outstanding from commercial borrowings and the rapid growth of debt service payments. According to Central Bank figures, commercial borrowings and suppliers' credits stood at around \$650 million at the end of 1983, with total external debt at \$2.8 billion. Debt service payments amounted to around \$300 million, pushing the debt service ratio to 21.6 percent.

All indications are that the foreign debt service burden will continue to rise steeply through most of the 1980's as grace periods expire and new loans are procured by both public and private sectors. Although much depends on export performance and terms of trade, it appears inevitable that the debt service ratio will also go up.

EXCHANGE RATE POLICY: Because of Sri Lanka's high rate of inflation relative to its trading partners since 1978, the rupee has devalued steadily against all major currencies except the French franc. In 1983, the rupee depreciated 14.7 percent vis-a-vis the dollar, from Rs. 21.32 to Rs. 25. According to the "flexible exchange rate" policy, the value of the rupee is set every day by the Government. During the first few months of 1984, it stabilized at around Rs. 25.15 to the dollar.

With accelerating domestic inflation and a strong rupee, imports have become relatively cheaper, while exports find it more difficult to compete on the world market. International financial institutions have made a number of well-publicized recommendations to allow the rupee to devalue further, to bring price equilibrium back to the external sector. However, because of the improvement in Sri Lanka's terms of trade, and concern about the domestic politico-economic impact of devaluation, the Government is reluctant to follow this advice.

II. IMPLICATIONS FOR THE UNITED STATES

GENERAL: In international affairs, Sri Lanka puts heavy emphasis on multilateral diplomacy and follows a strictly -- if moderate -- nonaligned foreign policy, balancing its relations carefully between the major power blocs. Bilateral relations between Sri Lanka and the United States are very good and mutually beneficial. Because of the critical importance of foreign trade and investment to its economic development, Sri Lanka has turned to the United States and to other OECD countries as natural partners in the economic arena. In 1983, the United States was by far the largest single market for Sri Lankan exports (\$185 million) and supplied about 16 percent of all foreign aid disbursed during the year (\$73 million). In addition, the United States is seen as a significant source of new foreign investment in the years ahead -- provided Sri Lanka continues to encourage and remove obstacles to such investment.

TRADE: The UNP Government remains firmly committed to its open trading policy, and shows no sign of considering a return to quantitative import controls. However, in view of Sri Lanka's chronic trade deficits, some restructuring of the tariff schedule is possible to give greater protection to import-substituting industries.

With a population of less than 16 million and per capita annual income of approximately \$300, Sri Lanka does not offer a particularly large market for U.S. exports. There are, however, several large capital development projects which might offer attractive opportunities for U.S. engineering and consulting firms, such as a proposed coal-fired power plant in Trincomalee, a single point buoy mooring system and related facilities at the Colombo port, and the aquaculture project financed by the Asian Development Bank.

In 1983, major U.S. exports to Sri Lanka were wheat, aircraft parts, and construction equipment. For 1984-85, the Embassy has identified the following products as having the best potential for additional U.S. sales to Sri Lanka:

- Power Generation, Renewable Energy, and Transmission Equipment
- Medical and Hospital Equipment
- Telecommunication Equipment
- Chemicals and Plastics

INVESTMENT: As of mid-1984, U.S. investment in Sri Lanka remains at a relatively modest \$14-15 million. American Express, Bank of America, and Citibank all have branch offices in Colombo, while Girard Bank and Bankers Trust have opened up representative offices. Other major U.S. investments -- many of them going back before 1977 -- include IBM, Pfizer, Singer, Union Carbide, Warner-Hudnut, Muller and Phipps, and NCR Corporation, several of whom have manufacturing facilities aimed at the Sri Lankan market. More recently, the Free Trade Zone has attracted U.S. investments such as Smart Shirts and Star Garments.

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The Government is interested in attracting more foreign investment to Sri Lanka, particularly in areas which will generate high employment, make use of Sri Lankan resources to the greatest extent possible, and result in a transfer of technology and managerial expertise. Agro-based industries, food and rubber processing, electronics, and mineral-based industries have been identified as areas of investment that are both promising and desirable. The tourism and garment sectors, on the other hand, which have attracted significant investment in the past, are now considered saturated.

The attractions of investing in Sri Lanka include a low-cost, literate, and trainable work force; tax incentives for export industries; and geographic proximity to Asian and Middle Eastern markets. Communal violence in 1983 and 1984 has tarnished Sri Lanka's attractiveness as a politically stable environment for investment. Other difficulties that have been observed include infrastructure bottlenecks such as power outages and poor roads, high electricity surcharges, capricious changes in laws and regulations governing banks, businesses, and credit, and often prolonged negotiations, particularly when dealing with the Government as a joint venture partner. Because of the structural weakness of Sri Lanka's external sector, foreign financing is usually a key component of any investment or major sales agreement.

Investing in the Free Trade Zone short-circuits many of the obstacles and offers a special attraction to U.S. firms interested in investing in Sri Lanka for export to overseas markets. Foreign investors are permitted 100 percent equity ownership, and imports are of course duty-free. Tax exemptions of up to 10 years are negotiable for investors in the FTZ, depending on characteristics of the project such as employment generation, foreign exchange earnings, and introduction of new technology. For investments outside the FTZ, tax holidays have been reduced due to Sri Lanka's growing revenue requirements. Tax exemptions up to 5 years are available only for non-traditional export industries and some types of agri-business.

U.S. investors will be interested to note that Sri Lanka is one of a handful of developing countries, worldwide, singled out for special emphasis in the "Private Enterprise Promotion" program under the U.S. Agency for International Development (AID). In the initial effort in this project to assist and invigorate the private sector, the U.S. consulting firm, Arthur D. Little, identified the most promising areas for new investment in Sri Lanka -- rubber-based industries, light engineering, minerals processing, fisheries, fruits and vegetables, and coconut products. The centerpiece of the AID project is the Sri Lanka Business Development Center which opens in July, 1984. The Center will provide a full range of advisory services to potential investors, serve as a focal point for analysis of investment policy issues and opportunities, and undertake management training and entrepreneur development. With AID assistance, a separate organization -- the Joint Agricultural Consultative Committee (JACC) -- has also been set up to promote Sri Lankan-U.S. joint ventures in the area of agro-based industry.

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GOVERNMENT OF SRI LANKA AND USAID PROJECT-RELATED POLICY DIALOGUE

General Approach: USAID carries on policy dialogue with the GSL at several levels. In the broader context of discussions on the overall U.S. assistance program and negotiations of the larger components such as the PL-480 Title I program, USAID does this in coordination with the IBRD and other donors. Sri Lanka reviews its policies and structural changes with other donors at the Annual Consultative Group Meeting. The USAID discusses macroeconomic and other policy issues in its paper, "Policy Dialogue Framework for Sri Lanka", April 1985. This paper addresses policy dialogue at the project level.

<u>Policy Dialogue Category</u>	<u>Progress to Date</u>	<u>Planned Actions</u>
1. <u>Agricultural Sector</u>		
A. <u>General</u>		
AID focuses its strategy and hence its dialogue with the GSL upon the GSL's objectives for the agricultural sector: to increase production, employment and income.	USAID has encouraged the GSL and provided it with resources to develop a National Agriculture Food-Nutrition Strategy and related investments policy. GSL established eight task forces to develop strategy proposals and policy options. They have undertaken several special studies, e.g., rural credit and marketing of subsidiary field crops. USAID has financed workshops, training and limited commodities. GSL to complete draft strategy by mid-1984.	Initiate USAID's Agricultural Planning and Analysis project in FY 86 to strengthen the GSL's agricultural planning and analysis capacity.
B. <u>Irrigation</u>		
Improved GSL organizational structure and policy framework for managing its irrigation systems with the farmers participating.	The GSL/USAID policy dialogue has included irrigation system operations and maintenance (O&M) as a major component. The current USAID irrigation project portfolio emphasizes improvements of O&M. The Water Management project provides for the development of an O&M operations model and the introduction of water user associations. The dialogue has resulted in restructuring the Irrigation Department and establishing a new Division of Irrigation Management with	USAID is presently designing two major projects (Irrigations Systems Management and Mahaweli Agriculture and Rural Development) which include major components dealing with O&M. Both projects will include appropriate mechanisms to assure that GSL complies with commitments to O&M, farmer participation, and water user charges.

Policy Dialogue CategoryProgress to DatePlanned Actions

a multidisciplinary cell. The cell will monitor performance and identify and analyze problems of irrigation systems island-wide. With the objective of building a financially self-supporting system, the GSL has instituted a system of water charges to go into effect in 1984.

The Mahaweli Basin I project financed an irrigation O&M manual for use by all Mahaweli systems. The Mahaweli Basin II project finances a technical assistance contract focussed on O&M in Mahaweli system B which began May 1985.

C. Cereals

Policies and programs to increase cereals production.

Government concentration upon rice research and extension plus use of the private sector for rice marketing has resulted in near rice self-sufficiency. Emphasis now shifts to subsidiary field crops. USAID began a Diversified Agriculture Research project in FY 84.

Five year goals for diversified agriculture research include:
(a) establishing eight research stations for selected subsidiary crops, and maintaining the rice research capability, (b) strengthening extension service's capability in subsidiary crops, (c) increasing certified seed production by the private sector, and (d) establishing an integrated market development program for subsidiary field crops.

D. Privatization

Policies and programs to increase private sector involvement in agricultural production and marketing.

USAID promotes private production of certified seed, private sales of other agricultural inputs and private marketing of farm produce. It also supports the development of private marketing and credit organizations in the Mahaweli and other irrigation areas. USAID involves private contractors in project implementation wherever feasible.

Under a recently signed technical assistance contract Coopers & Lybrand will assist the GSL and the new private Sri Lanka Business Development Center to expand services that facilitate private sector investment. USAID will continue policy initiatives described under "Progress to Date" and in other areas.

Policy Dialogue Category

Progress to Date

Planned Actions

USAID's Private Enterprise Promotion project emphasizes agro-business opportunities as does PRE's Joint Agricultural Consultative Corporation (JACC) program of collaboration between Sri Lankan and American investors.

2. Mahaweli Basin Development

Policies related to the settlement and agricultural development of the Basin area.

GSL expects to complete the construction of the major dams and canals of the irrigation systems by 1986. From 1986 onwards, the program will concentrate on the completion of downstream development.

The Mahaweli Agriculture and Rural Development Project to begin in FY 1986 will support: (1) improvements or changes in policies in the areas of water management and water charges; (2) improvements in the capacity of the GSL to plan, operate and maintain settlement and agricultural production activities; (3) manpower planning and strategies to promote business enterprises; and (4) new techniques in design and construction, and methods of data collection, analysis, operation, management and implementation.

3. Environmental Health

A. Water and Sanitation

Policies related to the design, finance, installation and maintenance of water supply and sanitation systems.

Water supply projects assist GSL to design, construct and rehabilitate water supply systems for town areas and to improve national capabilities to design, install and maintain water systems. It emphasizes water user charges and collection systems.

Increased community participation and adequate financing mechanisms remain prerequisites for implementing the Water Supply and Sanitation Project which began in FY 84.

Policy Dialogue Category

Progress to Date

Planned Actions

B. Malaria Control

Policies related to establishing an effective integrated vector control program.

The project has identified the pockets of chloroquin-resistant malaria in the Dambulla District. The Anti-Malaria Campaign has filled 82 of its 107 positions; it received 1.8 million pounds of malathion in December 1984.

The GSL will attempt to isolate and control the vector of the chloroquin resistant malaria. Lanka Market Research Bureau will complete a survey to identify constraints to malathion spraying and to the population's accepting treatment. The project team will devise strategies to address these constraints.

4. Housing

Policies relating to the design, financing, construction and management of low cost housing.

AID strives to replace the GSL with the private sector as designer, builder, financier, collector, and proprietor of the housing sector. Substantial participation by the private sector will induce other significant changes such as: elimination of subsidies, full cost recovery, availability of long-term financing, and standards and approaches (self-help housing and upgrading programs) that Sri Lanka society can realistically afford.

Future policy dialogue with the GSL, as a part of the overall HG program, will emphasize: (1) encouraging the development and use of a comprehensive housing policy; (2) improving the mechanism for establishing and servicing loans for shelter and related infrastructure, including the initiation of interest charges, to put GSL programs on a self-sustaining basis; (3) increasing the capacity to collect and manage data appropriately; and (4) strengthening the housing finance institutions in the servicing of shelter for low income households.

5. Private Sector

Policies which promote the development of the private sector and increase its participation in the economic development process.

The GSL promotes and USAID supports a greater role for the private sector in Sri Lanka's development. AID financed an assessment of the Sri Lankan private sector which a team completed in August 1983. The on-going USAID Private Enterprise Promotion project now funds a private sector development

The project team will complete initial assessment of project progress and requirements. The project will achieve the endowment fund goal for the Business Development Center.

Policy Dialogue Category

Progress to Date

Planned Actions

plan, assistance to specific institutions, entrepreneurial development programs, pre-feasibility studies for investments, and promotion of local and foreign investment. The project has created a new self-supporting institution, the Sri Lanka Business Development Center, which will generate a comprehensive program to expand the private sector's role in Sri Lanka.

ANE/ASIA/PNS, 5/14/85

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SUBJECT: LETTER FROM THE PRESIDENT TO PRESIDENT
JAYEWARDENE

REF: STATE 144751

1. - ENTIRE TEXT.

2. EMBASSY COLOMBO PLEASE DELIVER TO PRESIDENT
JAYEWARDENE THE FOLLOWING RESPONSE FROM THE PRESIDENT TO
PRESIDENT JAYEWARDENE'S LETTER DATED APRIL 19 (TEXT GIVEN
IN REFTEL).

3. BEGIN TEXT:

DEAR MR. PRESIDENT:

THANK YOU VERY MUCH FOR YOUR LETTER OF APRIL 19 IN WHICH
YOU DESCRIBE YOUR GOVERNMENT'S ECONOMIC PLANS AND
POLICIES. I APPRECIATED THE REVIEW OF YOUR GOVERNMENT'S
CONTINUING PROGRAMS OF ECONOMIC REFORM AND LIBERALIZATION
WHICH ALREADY HAVE BROUGHT SO MUCH BENEFIT TO SRI LANKA.

YOU HAVE GOOD REASON TO BE PLEASED WITH SRI LANKA'S

FAVORABLE ECONOMIC PERFORMANCE OVER THE PAST YEAR, MOST
NOTABLY IN REDUCING THE BALANCE-OF-PAYMENTS AND BUDGETS
DEFICITS. I KNOW FROM EXPERIENCE HOW DIFFICULT THAT CAN
BE. AS YOU POINT OUT; IT WOULD BE IMPRUDENT TO RELY ON A
CONTINUATION OF HIGH COMMODITY PRICES. FURTHER, MOVEMENT
IN THE DIRECTION OF ECONOMIC LIBERALIZATION WOULD APPEAR
TO BE THE BEST APPROACH IN CONSOLIDATING THE GAINS YOU
HAVE MADE TO DATE.

YOUR ECONOMIC PROGRESS IS ALL THE MORE IMPRESSIVE IN VIEW
OF THE CONTINUING COMMUNAL VIOLENCE IN SRI LANKA. WE ARE
SADDENED BY THE TERRIBLE ATTACK ON INNOCENT PEOPLE AT
ANURADHAPURA. AS IN OTHER INCIDENTS OF VIOLENCE AGAINST
PEOPLE OF ALL ETHNIC GROUPS IN RECENT MONTHS. LIKE YOU
AND OTHER SRI LANKAN LEADERS, WE WERE DISAPPOINTED THAT
THE ALL PARTY CONFERENCE ENDED WITHOUT REACHING AN
ACCORD. WE STRONGLY CONCUR WITH YOUR ASSESSMENT OF THE
NEED TO ACHIEVE A SATISFACTORY POLITICAL SETTLEMENT OF
THE COMMUNAL PROBLEM TO USHER IN AN EVEN MORE PROMISING
PHASE OF PEACE AND PROSPERITY IN SRI LANKA.

THE UNITED STATES REMAINS FIRM IN ITS SUPPORT FOR SRI
LANKA'S UNITY AND DEMOCRACY. WE WISH FOR PEACE IN SRI
LANKA, AND WELCOME THE OPPORTUNITY TO CONTINUE OUR
ASSISTANCE TO YOUR COUNTRY'S ECONOMIC DEVELOPMENT.

I HAVE PROVIDED COPIES OF YOUR LETTER TO THE DEPARTMENT
OF STATE AND THE AGENCY FOR INTERNATIONAL DEVELOPMENT FOR
THEIR USE IN PREPARING FOR THE SRI LANKA AID GROUP
MEETING IN PARIS.

SINCERELY, RONALD REAGAN. END TEXT. SNULTZ

Source: State 164146



8513905

President of Sri Lanka

19th April, 1985

My dear President,

The 21st Meeting of the Sri Lanka Aid Group is to be held in Paris on 20 June 1985. Eight previous meetings of this Group have been held since my Government was returned to power in Sri Lanka in July 1977. At each of these eight meetings, the donor Governments represented in the Aid Consortium have made very generous aid pledges to Sri Lanka. The aid given to us in pursuance of these pledges has been of invaluable assistance in promoting Sri Lanka's economic and social development. I wish, on behalf of the Government and people of Sri Lanka, to express my deep gratitude to the donor Governments for the substantial development assistance which they have extended to us in the past, and to express my fervent hope that they will continue to assist our development efforts in the future.

Soon after my Government assumed office in 1977, we introduced a wide-ranging package of economic reforms designed to stimulate the growth of Sri Lanka's economy. The economy was liberalised by dismantling the vast array of import and exchange controls which had inhibited the growth of production and trade in Sri Lanka. The private sector was given numerous incentives to develop and expand. Foreign investment was encouraged. The costly subsidies which had distorted the economy were sharply reduced. These were major changes in the economic policies which had been adopted by successive Sri Lankan Governments in the past. They resulted in the conversion of a closed and tightly controlled economy into a free and open one.

These economic reforms have had impressive results. Sri Lanka's economy has, over the past 7 years, grown at more than twice its previous rate. Agricultural production in particular has expanded

His Excellency Mr. Ronald Reagan,
President of the United States.

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rapidly, and we are now self sufficient in our staple food - rice. Unemployment, which was probably the most serious problem facing our Government when we took office in 1977 has been almost halved. Many new industries have sprung up and our industrial output, particularly in the private sector has risen sharply. We have been particularly encouraged by the response of foreign investors to the incentives which we have offered. Over 600 foreign investment projects have been approved since our Government assumed office and more than half of these are already in active operation. These projects bear testimony to the confidence which foreign investors have in the new economic policies which our Government has adopted and in the new economic climate which these policies have created.

The year 1984 has, from an economic standpoint, been a particularly favourable one for Sri Lanka. The sharp rise in the prices of our export commodities, and particularly in the price of tea, has had very beneficial effects both on the country's balance of payments as well as on the Government's revenue. Our external reserves are now sufficient to finance 5 months of the country's imports while the Government's Budget deficit which was running at approximately 23% of the GDP in 1980 has been sharply reduced to around 9% of the GDP in 1984.

Unfortunately, our past experience has shown us how volatile our commodity prices can be. We are aware that the high commodity prices which prevailed in 1984 are unlikely to continue. We are fully conscious therefore of the urgent need to adopt prudent economic and financial policies in order to conserve our limited resources and to ensure that they are used in the best possible manner. It is my Government's firm conviction that our resources can be used most effectively if the major part of the country's investment is made in the private sector. This has unfortunately not been the case in the past. Because of the massive capital expenditure which the Government has incurred in recent years on large development schemes like the Mahaweli Development Programme, an unduly large share of the country's total investment has been channelled into the public sector. The Government intends to change this situation in the future. In the 1985 Budget presented in Parliament by my Minister of Finance, substantial reductions were made in the rates of personal tax to ensure that sufficient savings would be available in

the hands of private investors for profitable investment in the private sector.

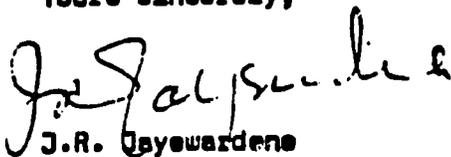
We hope that there will be a substantial increase of private sector investment in industry, agriculture, animal husbandry and fisheries over the next few years, and that this increased investment will result in a substantial expansion of production, particularly of production for export. The Government itself will confine its own capital expenditure largely to the provision of the essential infrastructure required for development, such as a good road system, increased power supplies and improved telecommunications, and to the maintenance and improvement of its existing assets, including in particular the rehabilitation of the tea and rubber plantations which are in Government hands. The Government will not embark on new industrial or agricultural projects which can, in my view, be better handled by the private sector.

I am fully confident that, over the next few years, Sri Lanka can maintain the relatively high growth rates which it has achieved in the recent past. We have achieved this growth inspite of the ethnic problems which have caused serious difficulties for my Government. I am actually conscious of the need to arrive at a speedy solution of these problems. My Government has been making, and will continue to make, every effort to achieve a satisfactory political settlement of our ethnic differences, because we realize how important such a settlement is for the future progress and prosperity of our country.

Your Excellency's Government has given Sri Lanka generous assistance in the past. I trust that the pledges which your representative will make at the forthcoming Aid Group Meeting will reflect your Government's continuing interest in Sri Lanka's future growth and development. It is in this hope and expectation that I am addressing this letter to you to seek Your Excellency's personal intervention in this matter.

With warm personal regards,

Yours sincerely,



J.R. Jayewardene
President of Sri Lanka

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MEETING OF THE SRI LANKA AID GROUP

Paris, June 21, 1984

Chairman's Report of Proceedings

Introduction

1. The twentieth meeting of the Sri Lanka Aid Group was held in Paris on June 21, 1984, under the chairmanship of the World Bank. The meeting was attended by delegations from the Governments of Sri Lanka, Australia, Canada, Denmark, Finland, France, the Federal Republic of Germany, Japan, The Netherlands, Norway, Sweden, the United Kingdom and the United States. Representatives of the the Asian Development Bank, the Commission of the European Communities, the International Monetary Fund, the United Nations Development Programme, and observers from Belgium, Switzerland, DAC/OECD and the International Fund for Agricultural Development also attended. The list of delegates and the agenda are attached as Annexes I and II. The statements of the World Bank, the IMF Representative and the ADB Representative and the Head of the Sri Lanka delegation are attached as Annexes III, IV, V and VI. The Chairman's Concluding Remarks are attached as Annex VII. The Press Release is attached as Annex VIII.

Opening Statement by the World Bank

2. In his opening remarks, the World Bank representative concentrated on three key areas: (i) major developments during 1983, (ii) a review of the basic economic trends during 1978-83; and (iii) impediments to further economic growth.
3. The World Bank representative noted that despite drought and civil disturbances, GDP growth in 1983 was only marginally lower than in 1982, and the budget deficit and the current account deficit in the balance of payments were substantially lower as a share of GDP than in 1982. These gains resulted partly from policy measures such as increased domestic resource mobilization, partly from a decline in capital expenditures, but mostly from a 14% improvement in the terms of trade.
4. Despite these improvements, the budget deficit at 15% of GDP and the current account deficit in the balance of payments at 12% were large. The terms of trade improvement did not lead to a reserve build up and by the end of the year, net international reserves remained negative. The public debt service ratio had risen rapidly to 18%. This mixed performance in 1983 underscores the basic structural weaknesses of the Sri Lankan economy.
5. The World Bank representative noted that there were two basic and related weaknesses: (i) the low level of national savings; and (ii) a distorted system of incentives. The Government's budgetary management has been a major contributing factor to the savings-investment imbalance. Since 1980, when the disequilibrium was the greatest, the Government has taken some steps

to reduce the budget deficit but further efforts are necessary to both reduce the size of public capital spending and improve the composition of the public investment program. The growth experience during 1978-83 illustrates the important role of incentives. Paddy, garments and tourism performed remarkably well, benefitting from liberalization and appropriate incentive measures; the tree crops, the public manufacturing sector and non-traditional exports (other than garments) performed very poorly as a result of distorted incentives.

6. The impressive growth rate during 1978-83 was maintained through a large increase in foreign assistance, commercial borrowing, and a drawdown of international reserves. Future aid commitments are unlikely to remain at the 1980-81 high levels, however, and further large commercial borrowings would be imprudent. Fiscal reforms to remove the savings-investment imbalance are, therefore, necessary. The tax structure should be reviewed to make it more elastic. In order to accommodate much needed additional resource requirements for operation and maintenance and for increased civil service salaries in the higher grades, the Government will have to reallocate expenditures away from low return uses such as subsidies to public corporations. Furthermore, a tightening of budgetary procedures with a view to restricting public capital expenditures is necessary. The World Bank representative commended the Government for taking some encouraging steps in this regard, such as the adoption of economic criteria for project selection, and the decision to introduce a separate O&M budget from 1985 onwards in order to ensure adequate allocations for this purpose.

7. A strong expansion of non-traditional exports would be essential to maintain the momentum of growth as there are clear limits to efficient import substitution and the benefits of Sri Lanka's current efforts to revitalize the tree crops sector will become available only after a number of years. This will be crucially dependent on providing a set of incentives to promote export growth.

8. Appropriate incentives and institutional support that have been the sources of growth in paddy production will have to be made available to other agricultural products, particularly tea, rubber and coconut. The formation of the National Agricultural and Food Policy Committee to advise on producer margins for agriculture is a welcome step. Apart from making this Committee operational as soon as possible, the Government needs to undertake management reforms in the state plantations and rationalize the multiple ministries and agencies in agriculture.

9. The World Bank representative regretted that there was little progress to improve the incentives structure in industry or the management of inefficient public enterprises. This sector can be a source of growth only if further policy changes, including tariff reforms, take place. Encouraging policy changes in the energy sector had taken place in recent months and that momentum should be maintained.

10. In conclusion, the World Bank representative cautioned that the current high prices and recent improvements in some economic indicators should not lead to complacency on the part of either the Government or the donor community. Substantial donor assistance will be necessary for Sri Lanka to implement structural reforms and establish a solid foundation for growth. Despite the current political difficulties, failure on the part of the Government to undertake the needed reforms will not only lead to economic problems but also make the resolution of the political problems difficult in the future.

Statement by the IMF Representative

11. The IMF representative noted that the wide-ranging economic reforms of 1977-78 and generous support from the donor community had revitalized the economy, increased employment, and raised per capita incomes. But the period since these reforms has also witnessed the emergence of imbalances between an ambitious investment program and availability of domestic resources. While public investment increased sharply, the Government was unable to generate necessary savings which reflected the adverse impact on revenue of three consecutive years of terms of trade deterioration, lack of buoyancy in the tax system and the poor performance of public enterprises. The persistent high rates of inflation were also not conducive to generate domestic savings. Sri Lanka thus financed its investment efforts increasingly through foreign savings, leading to the accumulation of a large foreign debt.

12. Given the rising external debt burden, policies are needed to reduce the current account deficit in the balance of payments. The current account deficit declined in 1983 to around 12% of GDP from 15% in 1982, largely as a result of improvement in the terms of trade owing to high tea prices. The current high tea prices cannot be sustained for long and Sri Lanka's terms of trade are likely to deteriorate in 1985.

13. The IMF representative cautioned that the current high commodity prices must not lead to relaxation of efforts for structural reforms. He welcomed the recent measures to tighten credit policy and recommended that the Government take further measures to bring down the inflation rate which accelerated since mid-1983.

14. The Government undertook a commendable expenditure pruning exercise in early 1984. But the tax base has to be expanded and the tax system's efficiency and buoyancy increased. Improvement in the financial operations of public enterprises is also needed to enable them to contribute to the domestic resource mobilization effort.

15. While welcoming the Government's priority to the rehabilitation of the tree crops sector, the IMF representative noted that a strong growth of non-traditional exports is crucial to ensure a viable balance of payments. In this connection, the distortions generated by the tariff structure need to be corrected.

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16. In conclusion, the IMF representative urged the Government of Sri Lanka to implement further policy reforms and the donors to provide assistance to Sri Lanka's adjustment efforts.

Statement by the ADB Representative

17. The representative from the ADB observed that, in spite of the acute economic difficulties facing the Government since 1977 in its budget and balance of payments positions, there had been major achievements in GDP growth and in a substantial reduction in unemployment. Furthermore, notwithstanding the civil disturbances and drought in 1983, the deficits in the budget and the current account of the balance of payments had declined relative to GDP as compared with 1982.

18. In discussing economic developments and prospects, the ADB representative concentrated his remarks on two major challenges now confronting Sri Lanka, namely increasing national savings and private sector development.

19. While the passage of economic reforms introduced in 1977 led to a remarkable increase in the investment rate and a doubling of the economic growth rate, the national savings rate did not improve to the extent required. Government savings were consistently negative and the small improvement in private savings resulted largely from an increase in the volume of remittances from Sri Lankans working abroad. The ADB representative noted that mobilization of domestic resources needs to receive greater attention than ever before in order to ensure that adequate domestic resources are available to meet the objectives of the 1984-88 public investment program. He added that the national savings rate can be raised only through the combined efforts of all concerned including the Government, corporations, households, and domestic financial institutions. The Government needs to curtail expenditures and raise revenues. The savings efforts of corporations in both the public and private sectors also need to be improved through measures to strengthen the quality of management. Education and publicity campaigns may be warranted to reinforce the savings ethic and increase household savings. The ADB representative also expressed his concerns with the availability of rural credit and observed that rural credit systems must be made more effective as a prerequisite for increased mobilization of rural savings. He noted with encouragement that the Government is considering the introduction of new arrangements for rural credit, possibly involving the establishment of regional rural banks.

20. The ADB representative also noted that one major objective of the Government's reforms in 1977 was to stimulate the growth of the private sector. The performance of the private sector since 1977 has been somewhat mixed. Recently, the Government has taken steps to involve private sector participation in a number of public sector industrial units. The Government has also decided that no new public investment should be undertaken in areas where the private sector is more suited.

21. The ADB representative concluded by recognizing that the issues which he had raised were receiving the attention of the Government.

Statement by the Head of the Sri Lanka Delegation

22. In his opening statement, the Honorable Ronnie de Mel, Minister of Finance and Planning and Head of the Sri Lanka delegation, noted the substantial economic gains made by Sri Lanka over the past six years. The economic policies introduced in 1977 started a process of structural change that marked a dramatic break from the inward-looking regulatory policies of the past. As a result, investment as a percent of GDP averaged almost 30% during 1978-83 as compared with 16% during 1970-77. In real terms GDP growth averaged 6.0% during the current period as opposed to 2.9% during the previous period. An estimated 1.2 million jobs were created during 1977-83. On the production front, the country has moved from a situation of importing 46% of its rice requirements in 1977 to a position of near self-sufficiency today.

23. The Minister recalled that these achievements were all the more remarkable as they took place against the background of an extremely hostile international economic environment characterized by the worst recession of the post-war era with high inflation, crippling interest rates, volatile exchange rates and deteriorating terms of trade. He added that Sri Lanka's economic progress had not been, however, without great difficulties. These difficulties in many ways stemmed from the very successes: the efforts to pull Sri Lanka out of the low investment, low growth and high unemployment syndrome had placed great strains on the budget and the balance of payments, especially in the context of this hostile external environment.

24. The Minister noted that a number of corrective measures aimed at domestic and external financial stability had been taken which should enable the country to achieve a better balance in the budget this year. The improvement in the fiscal position is expected to lead to a substantial surplus in the balance of payments. He noted that, in the same way as the deteriorating terms of trade were an important factor in causing many of the financial imbalances in the recent past, the current strengthening in the terms of trade, due to increased tea prices, was a major explanatory factor of the current improvement in Sri Lanka's macro-economic indicators. He added, however, that these good tea prices leave no room for complacency. On the contrary, the country is determined to use the current good export prices to build up reserves so as to be able to support sound structural change in the economy in the medium term. He also added that, although Sri Lanka's economy is now in reasonably good order, the task of structural change is a difficult one, and the country will need the continued support of the donor community. In addition, the Government is fully aware that sustained growth and development can be achieved only if there is political and social stability. The Government is determined to ensure that the traumatic events of July 1983 are not repeated, and a sustained effort is being made to evolve a durable solution to the very complex ethnic problem in the country.

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25. The fundamental objectives of the economy will be rapid economic growth, employment creation, price stability and structural change necessary for future growth. The Minister pointed to a number of recent decisions which will strengthen the institutional structure within which these objectives will be pursued -- a clear set of priorities has been identified; the whole process of project approval has been rationalized; and efforts are being made to improve public expenditure control as well as to evolve an overall incentive structure in the economy which will help channel resources into priority areas. The Minister highlighted two very important recent decisions relating to future strategies and priorities for development. As a first principle, it has been decided that no project will be undertaken by the state sector if it can be better handled by the private sector. Public investment is viewed basically as a means of providing infrastructure facilities necessary to support the private sector. Secondly, the Government has decided to allocate sufficient funds for operation and maintenance of existing assets before embarking on new investments.

26. The Minister discussed briefly the public investment program, the centerpiece of which will be the rehabilitation of the public plantation sector. He presented the Aid Group members with a document entitled, "The Medium Term Investment Programme - Project Identification Report", which is a summary of the package of programs prepared at several levels -- estate, regional, corporate and national -- covering 530 estates. Another high priority area of the investment program is the rehabilitation and maintenance of the country's road network, particularly the major arteries. While the slow growth of the economy during the period before 1977 did not overtax the existing facilities, the dramatic upsurge in economic activity after 1977 has put the country's infrastructure facilities, especially the road network, under severe pressure. Other high priority areas for the public sector will be energy development and agricultural diversification. With regard to the latter, the Minister also presented the Aid Group members with a document entitled, "National Agriculture, Food and Nutrition Strategy", which outlines the elements of a program of development for this sector. It is basically an exercise to identify priority areas for development and is an effective base document for the consideration of donor support in the coming years. The Minister concluded by emphasizing that the Aid Group support has played a major role in Sri Lanka's development programs during the past six years and would be invaluable in the future if the country is to pursue a path of continued development.

Observations by delegations

27. The delegations praised the Government for its past achievements which resulted from the successful liberalization strategy adopted in 1977-78. Despite unfavorable conditions, GDP growth in 1983 at 4.9% was commendable.

28. The delegates were very concerned, however, that a number of major structural issues have remained unresolved. While the Government has been

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successful in addressing some of the short-term problems, these persistent structural problems, unless tackled in time, could adversely affect Sri Lanka's growth rate in the medium term. Although the budget deficit and the current account deficit in the balance of payments declined in 1983, as a share of GDP, they still remain high. In addition, inflation accelerated during the past year and the debt service burden rose to high levels as a result of Sri Lanka's recourse to commercial borrowings abroad partly to finance budget deficits. The delegates emphasized that the Government would have to take further strong policy measures to achieve a sustainable budgetary and balance of payments position in the medium term. Some delegates felt that the Government's budgetary practices were, in fact, at the root of many of Sri Lanka's current macro-economic problems and need to be addressed as a priority item.

29. The delegates believed that further restraint in public spending would be necessary to rectify the imbalance between expenditures and available resources. In the past, high levels of public expenditures, particularly public investment, had contributed to the need for commercial borrowings abroad and increased the debt service burden. The Government will have to tackle the problem from both the expenditure and revenue sides. On the one hand, the Government needs to restrain public spending; on the other, increased domestic resource mobilization measures would have to be taken to raise the level of national savings.

30. Several speakers deplored the past neglect of operation and maintenance of existing facilities. They emphasized that adequate O&M expenditures are necessary in order to avoid costly rehabilitation of assets in the future. Several speakers welcomed the Government's decision to introduce a separate O&M budget from 1985 onwards and allocate sufficient funds for such activities. With increased demand for O&M expenditures and for higher wages in the public sector, the Government would have to consider to reduce the level of public investment further in order to reduce total public spending.

31. A number of speakers stressed the role of incentives in the development of the private sector and in exports growth. In this connection, they pointed to Sri Lanka's successful experience with rice and garments. The delegates felt that the tariff structure should be reformed to remove the current anti-export bias. One delegate felt that the Government would have to provide for training facilities of entrepreneurs, managers and skilled personnel to promote private industrial growth.

32. Several speakers referred to the lack of a coherent industrial strategy and its adverse effect on industrial growth. They were concerned that inefficient public enterprises continued to be a drain on the Government's budget. By improving enterprise efficiency and removing subsidies, public savings could be increased even in the short run. Several speakers felt that the Government's stated policy of privatization had not been acted upon. A number of reports including a report by the Parliamentary Committee on Public Enterprises and a UNDP financed study recommended measures

to improve efficiency of the public sector corporations. The Government needs to act upon these recommendations quickly.

33. A number of speakers referred to the composition of the Government's public investment program as the Accelerated Mahaweli Program nears completion. Questions were raised about priorities in public investment. The delegates felt that the Government must clearly define such priorities in advance. Maximum support should be given to the use and development of productive resources. Aid requests to donors should be consistent with such priorities. In this connection, several speakers felt that tree crops, export development, infrastructure rehabilitation and downstream development should enjoy high priority. As Sri Lanka nears self-sufficiency in rice, agricultural diversification also becomes important.

34. Several speakers were concerned about insufficient attention given to the social sectors. They cautioned that the social sectors should not suffer in the pursuit of a growth and liberalization strategy. One speaker pointed out that population growth had begun to accelerate in the recent past. The natural rate of population increase was now estimated at 2.1% per year. At this rate, Sri Lanka's population would double in some 30 years. Only outmigration has held the population growth rate down to the current 1.7% per year, but this high migration rate may not continue for long. These demographic trends require the Government's urgent attention. One speaker felt that family planning and population control programs do not receive sufficient allocations in the Government's budget. Other speakers were concerned about the adverse effect of the elimination of the food subsidy on child malnutrition. The Government may have to increase target based nutrition programs to counter these adverse effects. Referring to the Living Standards Study, jointly executed by the World Bank and the Central Bank of Ceylon and funded by several donors, some speakers hoped that an early completion of the study would reveal measures to reverse some of the disconcerting trends in nutrition and income distribution.

35. Several speakers referred to the Government's National Agriculture, Food and Nutrition Strategy study which was presented to the Aid Group. They felt that this strategy should subsequently be developed into implementable programs. The speakers hoped that these programs would relate to some of the important issues raised in the meeting, including agricultural diversification, rice self-sufficiency and nutritional improvements.

36. Several delegates referred to the lack of coordination between various agencies and ministries. There were overlapping ministries and agencies in some sectors or even subsectors. These overlapping jurisdictions need to be rationalized. One speaker referred to problems of coordination between national planning and planning at the regional/district level. Linkages and support systems have to be developed between these various planning levels.

37. The delegates expressed deep concern about the ethnic troubles which erupted last year. They cautioned the Government about the adverse impact of such disturbances on Sri Lanka's economic development efforts. They felt that an equal participation of all communities in the process of development and an equitable distribution of its benefits were necessary to ensure stability and sustained growth. The delegates expressed hope that the Government would be able to find an early solution to the communal problems.

Response to Observations of Delegations

38. After the observations of the delegations, the Chairman invited Mr. Ronnie de Mel, Minister of Finance and Planning and the head of the Sri Lanka delegation to give a brief response particularly to the question on the ethnic troubles which will require solutions at the political level. The Minister stated that the two major communities, the Sinhalese and the Tamils, represented about 74% and 13%, respectively, of Sri Lanka's total population. The two communities have lived together for almost 2,000 years. The Minister provided considerable historical background to the current ethnic situation and thereby gave the opportunity for the delegates to gain a better understanding of a clearly complex problem. He stressed that the Government is very determined to resolve the issue. The All-Party Political Conference has been given the mandate to recommend remedial measures acceptable to both communities.

39. With reference to concerns of the delegates about structural macro issues, the Minister pointed out that the Government had reduced the overall budget deficit from 23% in 1980 to 13% in 1983. It is the Government's objective to reduce it further to 9% by the end of 1984. In order to reduce the current account deficit in the balance of payments, the Government has recently taken some measures to increase exports. Tax exemptions are now allowed only to export and import substitution activities such as sugar and livestock. It is the Government's target to reduce the current account deficit to 5% of GDP by 1988. Inflation declined to 10% in 1982 from a high level of 35% in 1980. Although inflation accelerated in 1983, the Government has taken some measures as a result of which decelerating trends are already visible. Inflation which now stands at 18% per year should decline to about 10% by the end of 1984.

40. The Minister then outlined the Government's priorities for investments. These are: (i) completion of ongoing schemes, (ii) consolidation of past investments, (iii) rehabilitation of infrastructure in transport, water supply, irrigation, and (iv) energy. New schemes based on such priorities would start only in 1986. There are a number of schemes in the energy sector which are under preparation, for example, Rantambe, Samanalawewa hydro power, and the coal-based thermal station. The Minister also emphasized that the Government would maintain Sri Lanka's past social achievements and pay due attention to income distribution, nutritional standards, population control and family planning in its investment program.

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41. After Mr. de Mel's brief response, Dr. W.M. Tilakaratna, Secretary, Ministry of Finance and Planning, responded further to the comments and questions raised by various speakers. Dr. Tilakaratna agreed with the macro-economic concerns expressed by the delegates and recognized the need for further improvements in the major macro indicators. He agreed that the basic problem was continued large budget deficits resulting primarily from too high a level of public capital spending. The budget deficit fueled inflation, contributed in large measure to the current account deficit in the balance of payments, and forced the Government to resort to unsustainable levels of commercial borrowing. He argued that the Government had to embark upon an ambitious investment program in 1977 in order to quickly meet the requirements of energy, infrastructure rehabilitation and achieve self-sufficiency in food. The Government has already undertaken a number of measures to reduce investment, increase national savings, and bring the budget deficit to manageable levels. As a result, total investment as a proportion of GDP is expected to decline from 29% in 1983 to an average of 26% during 1984-88, with public investment declining from 16% of GDP in 1983 to 14% during the latter period. At the same time, it was the Government's objective to increase domestic resource mobilization as a result of which foreign financing is expected to decline from 12.8% of GDP in 1983 to about 6% in 1988. The Government also did not propose to take recourse to the banking system to finance budget deficits except during exceptional short periods. He mentioned that inflation which was running at an annualized rate of 21% at end-1983 had already declined to 18% by end-May, 1984. Dr. Tilakaratna outlined a number of policy measures which had brought about this decline. The Government imposed a freeze on private sector credit in October 1983 as a first step and replaced it in November by increasing the statutory reserve requirements for both demand and time deposits and other measures to tighten credit. Further, the Central Bank of Ceylon would issue securities to the commercial banks and the two plantation corporations to mop up excess liquidity. On the fiscal policy side, the Government decided not to borrow from the banking sector during 1983; in fact, it would retire some of its debt resulting in deflationary pressure. Dr. Tilakaratna agreed that the current interest rates were too high to promote private investment but argued that the rates would come down once inflation was brought under control. The Treasury has decided not to fix interest rates in future and would pay for the Treasury Bills the interest rates determined by market forces.

42. Dr. Tilakaratna concurred that public enterprises were a burden on the budget and there were powerful vested interests wanting to perpetuate the system. After long discussions, the Committee of Development Secretaries recently approved draft legislation to convert government-owned business undertakings and some public corporations into private companies. Some shares of the converted companies would be made available to the workers. But these corporations were undercapitalized; a group of accountants are working to resolve the undercapitalization problem.

43. As regards the Government's industrial and tariff policy, Dr. Tilakaratna explained that the Presidential Tariff Commission (PTC) is expected to submit final recommendations about tariff reforms by end-August 1984. The Committee had earlier recommended tariff reforms for 60 relatively unimportant items out of which 57 recommendations were accepted by the Government. Tariffs on the important traded items are to be tackled in the next round of PTC's recommendations.

44. As regards exports incentives, Dr. Tilakaratna noted that the bias in the tax system against exports had been removed by the abolition of tax holidays other than for export and some import substitution industries. The tariff reforms are expected to remove further the anti-export bias. The poor export performance resulted from not only the anti-export bias but also the prolonged recession and the quota restrictions in the industrialized countries.

45. The Government was reviewing the tax system to introduce greater elasticity and buoyancy. An incentive scheme for tax officials was under consideration as part of efforts to improve the tax administration.

46. The Government is concerned about possible adverse effects of the liberalization policy on income distribution and nutrition. In this context the recently started Living Standards Study, when completed, should produce useful and conclusive results. While there may have been a relative decline in public expenditure on social sectors, higher employment as a result of the liberalization policy has increased incomes of the poor. A recent Government decision to increase wages of estate labor and to introduce incentives would increase the family income of this poor section of the population.

47. As regards the composition of the public investment program, Dr. Tilakaratna noted that Public Investment, 1984-88 includes the Government's priorities as well as procedures to be used for inclusion of new investment projects. These priorities are: (i) completion of ongoing projects, (ii) infrastructure rehabilitation, (iii) tree crops, (iv) power generation and distribution, and (v) import substitution activities such as sugar, animal husbandry, dairy, fisheries. The directly productive activities would be undertaken only in case of insufficient private sector interest. Mahaweli downstream development would enjoy the highest priority as part of an ongoing program. The Government would also undertake programs for manpower development, particularly in management, so that private sector development is not constrained because of skill shortages. The Sri Lanka Business Development Center is providing training in entrepreneurial development. Evening courses in business administration have been started at the university level. The National Institute of Business Management and the Sri Lanka Institute of Development Administration provide training facilities to the private sector also. The Government recently set up an Administrative Reforms Committee to recommend steps for improvement in public administration. The World Bank plans to carry out a study of public administration and business and industrial management.

48. The Government was conscious about the need to improve social welfare conditions in the estates. Programs are underway for improvement of schools, water supply and sanitation, and health facilities. The National Agricultural, Food and Nutrition Strategy would now be translated into programs for implementation by line ministries. The allocation to population control and family planning in the investment program may appear low but the problem in this sector is ineffective implementation rather than insufficient allocation. The Government would allocate sufficient funds for the sector as and when implementation improves.

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Chairman's Concluding Remarks

72. In his concluding remarks, the Chairman stressed the urgency for the Government to take decisive actions towards resolving the major structural problems which now cloud Sri Lanka's economic future. He pointed to frequent policy inaction in the past, to the gap between declared intent of Government and practice, and noted that, although the economy somehow or other had managed to make it through each year and continue to grow, moves to strengthen the longer-term economic outlook must be undertaken soon lest the growth momentum risks being lost and donor confidence undermined. The Chairman impressed upon the Sri Lankan delegation the importance of this message and of its being passed on to the Government Cabinet.

73. The Chairman then briefly touched upon some of the major structural issues that afflict the national economic outlook. He discussed the importance and urgency of establishing a suitable incentives' framework including, among others, adequate interest rate and exchange rate policies, so as to encourage greater private sector participation in the growth process. He referred to the need for greater budget discipline, for improvements in the efficiency and financial performance of public sector enterprises, for a thorough re-examination of government subsidies which are a heavy burden on the budget, and, in the light of the serious depletion in the country's economic physical infrastructure, for giving necessary operation and maintenance expenditures priority over the launching of new projects. The Chairman also discussed the issue, raised by several delegations, of the possible slippage during the past few years in the level of living of many Sri Lankans, and he urged the Government to give this subject an early review; given evidence of a slight increase recently in the population growth rate, he suggested that national demographic trends and the effectiveness of the family planning program be reviewed. He also stressed the urgency of examining and rationalizing the organization, structure and functioning of the national administration as there is much room for enhanced efficiency and greater cost effectiveness in dealing with the nation's needs. Finally, the Chairman emphasized that the Public Investment Program for 1984-88 be re-examined thoroughly with the objective of ensuring, among others, that necessary operation and maintenance expenditures are accounted for and, in function of resource constraints, some large new projects possibly deleted or postponed. He underlined the importance of reactivating local aid group meetings with the objective of ensuring a close coordination between donors and Government in the selection, financing and implementation of projects.

74. The Chairman concluded by asking for a continued commitment on the part of the Government to sound economic management and a careful matching of declared intent and Government actions, and he suggested that donor confidence in the Government's following this course of action is the basis for the substantial indications of aid at this meeting.

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SUBJECT: SUMMARY: THE SRI LANKA AID GROUP MET IN PARIS
ON JUNE 21, 1984

DONORS PLEDGED A TOTAL OF DOLS 541 MILLION FOR FISCAL 1984/5, OF WHICH DOLS 168 MILLION IS COMMITTED TO THE MAHAWELI PROGRAM. THE LEVEL OF AID INDICATIONS WAS 15 PERCENT HIGHER THAN THAT GIVEN THE PREVIOUS YEAR. WITHIN THAT TOTAL, FOOD AND COMMODITY AID PLEDGES WERE SOMEWHAT LOWER. THE CENTRAL MESSAGE OF THE AID GROUP TO THE GOVERNMENT OF SRI LANKA CONCERNED THE NEED TO IMPLEMENT, AS OPPOSED TO MERELY PLAN, A SUBSTANTIAL STRUCTURAL ADJUSTMENT PROGRAM IN ORDER TO SUSTAIN ECONOMIC AND SOCIAL PROGRESS. END SUMMARY

1. THE TWENTIETH MEETING OF THE SRI LANKA AID GROUP WAS HELD IN PARIS ON JUNE 21 UNDER THE CHAIRMANSHIP OF WORLD BANK VICE-PRESIDENT DAVID HOPPER. THE FOLLOWING COUNTRIES WERE REPRESENTED: AUSTRALIA, CANADA, DENMARK, FINLAND, THE FRG, JAPAN, THE NETHERLANDS, NORWAY, SWEDEN, THE UK AND THE UNITED STATES. REPRESENTATIVES OF THE ADB, THE COMMISSION OF THE EUROPEAN COMMUNITIES, THE IMF, THE UNDP, AS WELL AS OBSERVERS FROM BELGIUM, SWITZERLAND, DAC/OECD AND IFAD ALSO ATTENDED.

2. THE SRI LANKA DELEGATION WAS LED BY MR. PONNIE DE MEL, MINISTER OF FINANCE AND PLANNING. THE DISCUSSION FOCUSED ON THE ECONOMIC GAINS MADE BY SRI LANKA OVER THE PAST SIX YEARS, THE ACCOMPANYING STRAINS ON THE BUDGET AND BALANCE OF PAYMENTS, AND THE MEDIUM-TERM OUTLOOK.

3. THE STATEMENT BY U.S. DELEGATION EMPHASIZED AGREEMENT WITH WORLD BANK ANALYSIS THAT RECENT ACTIONS BY THE GSL HAVE MOSTLY ADDRESSED SHORT-TERM CONCERNS RATHER THAN THE UNDERLYING STRUCTURAL WEAKNESSES IN THE ECONOMY. SPECIFICALLY, THE U.S. CALLED FOR CONTINUED

EFFORTS TO REDUCE THE SIZE OF THE PUBLIC INVESTMENT BUDGET, INCREASE THE PROPORTION OF FUNDS ALLOCATED FOR OPERATIONS AND MAINTENANCE OF THE EXISTING INFRASTRUCTURE, AND IMPROVE DOMESTIC RESOURCE MOBILIZATION. U.S. ALSO NOTED CONCERN THAT POPULATION PROGRAMS ARE BEING GIVEN LOW PRIORITY, GIVEN CURRENT DEMOGRAPHIC TRENDS: IT IS ONLY THE CONTINUED HIGH LEVELS OF OUT-MIGRATION THAT HOLD THE POPULATION GROWTH RATE TO 1.7 PERCENT, AND SUCH RATES OF OUT-MIGRATION ARE UNLIKELY TO CONTINUE INDEFINITELY.

4. AMONG OTHER DONORS THERE WAS A MARKED DEGREE OF UNANIMITY IN SUPPORT OF WORLD BANK CONCLUSIONS AND RECOMMENDATIONS. ALMOST ALL DELEGATIONS POINTED TO STRUCTURAL IMBALANCES IN THE BUDGET AND BALANCE OF PAYMENTS AS THE KEY UNDERLYING PROBLEMS IN THE SRI LANKAN ECONOMY. ON THE BUDGET, THERE WERE VARIOUS SUGGESTIONS FOR MOBILIZING DOMESTIC RESOURCES THROUGH TAXATION AND/OR VOLUNTARY SAVINGS SCHEMES. POOR MANAGEMENT OF PARASTATALS CAME IN FOR SPECIAL CRITICISM, AND SUGGESTIONS WERE MADE FOR MAKING THEM MORE EFFICIENT, OR TURNING THEM OVER TO THE PRIVATE SECTOR AS A MEANS OF REDUCING THE DRAIN ON GOVERNMENT RESOURCES. SEVERAL DELEGATIONS STRESSED THE NEED TO SPEND THE NEXT FEW YEARS REHABILITATING ECONOMIC AND SOCIAL INFRASTRUCTURE, BRING NEW RIGOR INTO THE MANAGEMENT OF THE DEVELOPMENT PROCESS, AND CONSOLIDATE THE GAINS OF MAHAWELI RATHER THAN LAUNCH NEW PROJECTS. THERE WAS GENERAL CONCERN OVER PROJECTED EXTERNAL DEBT SERVICE PAYMENTS, AND OVER THE LACK OF CONVINCING PROGRESS IN DEVELOPING A DIVERSIFIED EXPORT BASE. MANY EXPRESSED THE HOPE THAT THE GSL WOULD USE THE WINDFALL EARNINGS FROM RECENT HIGH TEA PRICES TO BUILD UP FOREIGN EXCHANGE RESERVES TO SUPPORT NECESSARY STRUCTURAL ADJUSTMENT.

5. A NUMBER OF DELEGATIONS, MOST NOTABLY THE NORDICS, EXPRESSED CONCERN OVER THE POSSIBILITY THAT LIVING STANDARDS AMONG LOWER-INCOME GROUPS HAD DETERIORATED DURING THE YEARS OF HEAVY CAPITAL EXPENDITURE AND ECONOMIC LIBERALIZATION. DONORS ARE LOOKING FORWARD TO THE RESULTS OF THE IBRD-SWEDISH LIVING STANDARDS STUDY AND HOPE THAT IT WILL BE ACTED UPON. VIRTUALLY ALL DELEGATIONS REFERRED TO RECENT COMMUNAL PROBLEMS AS A POTENTIALLY SERIOUS CONSTRAINT TO FUTURE ECONOMIC DEVELOPMENT, AND URGED THE GSL TO INTENSIFY ITS EFFORTS TOWARD RECONCILIATION.

6. THE GENERAL TONE OF DONOR COMMENTS WAS ONE OF INCREASING TOUGHNESS IN CALLING FOR STRUCTURAL ADJUSTMENTS WHICH HAD BEEN PROMISED BUT HAD NOT MATERIALIZED IN RECENT YEARS. AS STATED BY THE BRITISH DELEGATE: QUOTE YES, WE DO CONGRATULATE YOU ON MEASURES YOU HAVE TAKEN IN THE LAST SEVEN YEARS SINCE 1977, BUT WE DOUBT THAT THEY WILL BE ENOUGH TO GET YOU THROUGH THE NEXT SEVEN YEARS. UNQUOTE

7. THE SRI LANKA DELEGATION STATED THAT DURING THE PERIOD AHEAD THE COUNTRY INTENDS TO CONSOLIDATE AND BUILD ON RECENT GAINS. THE CURRENT STABILIZATION POLICIES ARE PRODUCING RESULTS AND ARE EXPECTED TO LEAD TO A SUBSTANTIAL SURPLUS IN THE BALANCE OF PAYMENTS IN 1984, AND TO A FURTHER REDUCTION IN THE BUDGET DEFICIT. NO PROJECT WILL BE UNDERTAKEN BY THE STATE SECTOR IF IT CAN BE HANDLED BETTER BY THE PRIVATE SECTOR. OPERATION AND MAINTENANCE (O&M) EXPENDITURES ARE TO TAKE PREFERENCE OVER NEW INVESTMENTS.

8. IN HIS SUMMING UP, CHAIRMAN HOPPER NOTED THAT MAHAWELI HAS DOMINATED THE AID GROUP AND GSL THINKING IN PAST YEARS. THE AID GROUP HAS HOWEVER ALSO EXPRESSED

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DEEP CONCERN ABOUT THE NEED FOR STRUCTURAL REFORM. THE ELECTIONS AND THE COMMUNAL DISTURBANCES WHICH DISTRACTED ATTENTION FROM THIS URGENT BUSINESS ARE NOW BEHIND US, AND UNEXPECTEDLY HIGH TEA PRICES HAVE GIVEN BREATHING SPACE ON THE BALANCE OF PAYMENTS. THE GSL MUST NOW ASST. THE CRITICAL NEEDS ARE FOR: (A) BUDGETARY DISCIPLINE; (B) DOMESTIC RESOURCE MOBILIZATION; (C) A CHANGED INCENTIVE STRUCTURE TO STIMULATE THE PRIVATE SECTOR AND EXPORTS; AND (D) REDUCTION IN FOREIGN BORROWING. THESE PRIORITIES WILL WORK BEST IF ADDITIONAL DOMESTIC RESOURCES CAN BE MOBILIZED AND COMPLEMENTED WITH EXTERNAL RESOURCES IN A STRATEGIC APPROACH APPROVED BY THE ENTIRE CABINET.

9. THE PRESCRIPTION: A PAUSE IN INVESTMENTS, WITH A VERY CAREFUL EXAMINATION OF WHAT NEEDS TO BE REHABILITATED. A GENUINE EFFORT TO FULLY ENGAGE THE PRIVATE SECTOR, AND A SERIOUS, SUSTAINED EFFORT TO ADDRESS STRUCTURAL ISSUES. FURTHER, HOPPER NOTED THAT AN UNDERSTANDING HAS EXISTED BETWEEN THE GSL AND THE AID GROUP TO THE EFFECT THAT ADDITIONAL FUNDS WOULD BE MADE AVAILABLE FOR MAHAWELI, BUT ON CONDITION THAT THE POLI WOULD BE MAINTAINED. IN FACT, IT HAS BEEN PERMITTED TO GO DOWN. IN THIS CONNECTION, IT IS GENERALLY AGREED THAT SRI LANKA IS APPROACHING THE DANGER POINT IN ITS POPULATION GROWTH. FINALLY, HOPPER WARNED THAT FAILURE TO MAKE SIGNIFICANT PROGRESS DURING THE COMING YEAR COULD RESULT IN SERIOUS EROSION OF DONOR CONFIDENCE.

10. SEVERAL POINTS WORTH SPECIAL MENTION EMERGED FROM THE FORMAL STATEMENTS AND THE QUESTION AND ANSWER SESSION DURING THE MEETING:

(A) ALL DONORS SHOWED CONCERN ABOUT THE DILATORY NATURE OF THE GSL DECISION-MAKING PROCESS, POLITELY CHARACTERIZED BY THE CANADIAN DELEGATE WITH THE PHRASE QUOTE LESS THAN DETERMINED FOLLOW-THROUGH. UNQUOTE. WE HOPE THAT THESE EXPRESSIONS WILL BE USEFUL TO MINISTER DE MEL AND HIS COLLEAGUES IN PUSHING THROUGH NECESSARY ACTIONS.

(B) THE DONORS REACTED POSITIVELY TO THE GSL'S INITIATIVE IN PUTTING FORWARD A COORDINATED AGRICULTURE, FOOD AND NUTRITION PLANNING DOCUMENT. INTER-MINISTERIAL COORDINATION REMAINS A TROUBLED AREA. THE GSL-PROPOSED STRATEGY MAY HELP OVERCOME PLANNING AND IMPLEMENTATION PROBLEMS IN THIS KEY SECTOR.

(C) THE SRI LANKAN DELEGATION'S ASSURANCE THAT FAMILY PLANNING REMAINS A PRIORITY WAS WELCOMED, AS WAS THEIR INDICATION THAT THE IMPORTANCE OF REVISING EXPORTS IS RECOGNIZED. WITH REGARD TO THE KEY PLANTATION SECTOR, WE AGREE WITH THE UK DELEGATE'S POINT CONCERNING THE INTERCONNECTEDNESS OF PROGRESS ON THE SOCIAL AND PRODUCTIVITY FRONTS.

(D) PERHAPS MOST WELCOME OF ALL WAS THE SRI LANKAN DELEGATION'S INDICATION THAT CLEAR PRIORITIES FOR FUTURE INVESTMENTS HAVE BEEN IDENTIFIED. FIRST IS DOWNSTREAM DEVELOPMENT OF MAHAWELI. SECOND WILL BE INFRASTRUCTURE REHABILITATION AND O&M EXPENDITURES. (THE GSL HAS DECIDED TO INTRODUCE A SEPARATE O&M BUDGET FROM 1985 ONWARDS). THIRD, NEW INVESTMENTS IN THE PLANTATION,

POWER, SUGAR, AND QUOTE MINOR EXPORT CROPS UNQUOTE SECTORS. SHULTZ

PART II - WORLD BANK GROUP OPERATIONS

17. Since the beginning of its operations in Sri Lanka in 1954, the World Bank has approved 10 loans totaling US\$127.7 million (net of cancellations) and 37 credits totaling US\$712.6 million (net of cancellations) in support of 47 projects. About 52 percent of World Bank assistance has been for agriculture (irrigation, tree crops, and rural and dairy development), 23 percent for power, 10 percent for transportation, and the remainder of 15 percent among development finance company operations, a program credit (involving the import of raw materials for industry), water supply, construction industry, telecommunications, and small and medium industries. Eight loans and 13 credits have been fully disbursed. Annex II contains a summary statement of World Bank Group operations as of September 30, 1984.
18. In Sri Lanka, the IFC has a total investment of US\$2.13 million equivalent in equity and US\$16.74 million equivalent in loans. Investments have been made so far in two textiles industries, one polypropylene bag industry, one equipment-leasing company, one hotel, and two IFC lines of credit, one of which has been extended to the government-owned Bank of Ceylon for term loans to medium-sized industries.
19. The World Bank's current strategy is primarily to assist Sri Lanka in reaching a more sustainable balance-of-payments position in the medium term through export promotion and import substitution in viable economic activities. In order to achieve this, the lending strategy includes support to policy changes in a number of macroeconomic areas: investment priorities, the incentive framework, coordination of economic policies and programs, operational and maintenance expenditures and cost recovery. Projects currently under preparation include a fourth tree crops project and second dairy development project.
20. Within the above framework, the World Bank lending program concentrates resources on productive sectors, energy, and infrastructure. Within agriculture, the strategy gives the highest priority in the vital tree crops subsector. The objective is to channel resources into an activity in which Sri Lanka has a comparative advantage so as to stabilize the subsector in the short term and to promote sustainable export growth in the medium term. Whether in the irrigation, rural development or tree crops subsectors, the strategy focuses on rehabilitating the existing capital base, increasing its utilization capacity, and to ensure better operation and maintenance in the future.
21. The Government's priority to rehabilitate rundown infrastructure is well placed and needed to support expanded economic activity, particularly in the private sector. Major elements of the lending program would be directed at helping the energy needs of the economy and easing transport bottlenecks. The World Bank has provided financing to a number of power projects for generation, transmission and distribution. The future program would focus on energy conservation through both required investments and policy measures. The old and inefficient power distribution system would be rehabilitated to reduce system losses; small but significant improvements in energy conservation would be undertaken in large energy consuming industrial/commercial units; and a study, to be completed shortly, would recommend measures to improve energy efficiency in the transport sector, a large consumer of commercial energy in Sri Lanka. All of these activities would be supported

through policy measures and institutional development. Support to the transport sector would continue with rehabilitation of the road network, institutionalizing proper maintenance methods and improving sectoral planning of policies and programs.

22. The World Bank has provided financing for a broad range of large-, medium- and small-scale industrial enterprises, in the private sector, through support of development finance companies. Export development would primarily focus on this assistance which has also included support to improving the performance of private enterprises. Future lending in the sector would continue to emphasize this focus.

23. Institutional capabilities, in both the planning and the implementation areas, have been constrained with the recent expansion of public investment. Past World Bank projects have included an institution building component. In addition to this project, the future strategy would focus more on issues such as human resource development, business and industrial management, and public administration. Public administration constraints which affect the performance of all sectors would be identified and addressed directly through the lending program.

24. The need for a substantial transfer of resources to Sri Lanka has been a recurrent theme of World Bank economic reporting, both to offset the deterioration in the world trade environment and to support a high and sustained growth rate. Despite Government's increased domestic resource mobilization effort in the recent past, World Bank projects in Sri Lanka have included sector financing of local expenditures. The World Bank strategic focus on agriculture, rehabilitation rather than new infrastructure, institutional development means that the foreign exchange component of projects tends to be small. Also, the Government's budgetary situation continues to be tight as increased operation and maintenance requirements make demands on domestic resources.

25. The World Bank, as of the end of 1983, accounted for 10.7 percent (IBRD, 1.6 percent; IDA, 9.1 percent) of Sri Lanka's total debt outstanding and disbursed, and 5.0 percent of debt service on medium- and long-term debt. The projected World Bank's share in total existing external debt outstanding and disbursed will increase to 17 percent by 1985 (with IBRD's share declining to 1.3 percent). The IBRD and IDA portions of debt service are expected to decline to about 4 percent by 1985.

THE STATUS OF BANK GROUP OPERATIONS IN SRI LANKA

A. STATEMENT OF BANK LOANS AND IDA CREDITS (as of March 31, 1985)

Loan or Credit No.	Year	Borrower	Purpose	US\$ Million		
				Bank	IDA	Undisbursed
Eight loans and thirteen credits fully disbursed				72.9	96.1	
701	1977	Sri Lanka	Mahaweli Ganga Development II		19.0	9.2
818	1978	Sri Lanka	Tree Crop Rehabilitation (Tea)		21.0	9.3
891	1979	Sri Lanka	Kurunegala Rural Development		20.0	8.9
900	1979	Sri Lanka	Road Maintenance		16.5	6.3
931	1979	Sri Lanka	Agricultural Extension and Adaptive Research		15.5	10.6
942	1979	Sri Lanka	Small and Medium Industries		16.0	2.9
979	1980	Sri Lanka	Mahaweli Ganga Technical Assistance		3.0	1.4
994	1980	Sri Lanka	Road Passenger Transport		53.0	17.4
1017	1980	Sri Lanka	Smallholder Rubber Rehabilitation		16.0	12.1
1020	1980	Sri Lanka	Telecommunications		30.0	4.9
1041	1980	Sri Lanka	Second Water Supply		30.0	17.2
1048	1980	Sri Lanka	Sixth Power		19.5	10.0
1079 /a	1981	Sri Lanka	Second Rural Development		33.5	15.4
1130 /a	1981	Sri Lanka	Construction Industry		13.5	4.8
1160 /a	1981	Sri Lanka	Village Irrigation Rehabilitation		30.0	19.2
1166 /a	1981	Sri Lanka	Mahaweli Ganga Development III		90.0	36.4
1182 /a	1982	Sri Lanka	SMI II		30.0	24.4
1210 /a	1982	Sri Lanka	Seventh Power		36.0	14.0
1240 /a	1982	Sri Lanka	Tea Rehabilitation and Diversification		20.0	12.7
2187	1982	Sri Lanka	Eighth Power	42.7	-	10.4
1317 /a	1982	Sri Lanka	Forestry I		9.0	8.0
1363 /a	1983	Sri Lanka	Third Rural Development		23.0	20.0
1401 /a	1983	Sri Lanka	Industrial Development Project		25.0	18.0
1494 /a	1984	Sri Lanka	Mahaweli Ganga Development IV		30.0	30.0
2437 /b	1984	Sri Lanka	Mahaweli Ganga Development IV	12.1		12.1
1537 /a	1985	Sri Lanka	Major Irrigation Rehabilitation		17.0	17.0
TOTAL						
of which has been repaid				127.7	712.6	352.6
Total now outstanding				49.7	5.6	-
Amount sold				78.0	707.0	
of which has been repaid						
Total now held by Bank and IDA /c				78.0	707.0	
Total Undisbursed				10.4	342.2	352.6

/a IDA 6th Replenishment Credits, principal amounts shown in US dollars equivalent at date of negotiations, as shown in the President's Reports and undisbursed amounts shown in US dollars equivalent at the rate of exchange for the SDR at March 31, 1985.

/b Not yet effective.

/c The original principal of credits under replenishments 1, 2 and 3 has been increased by the amount of the translation adjustment as a result of the devaluation of the US dollar in 1972 and 1973.

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UNITED NATIONS
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PROGRAMME DES NATIONS UNIES
POUR LE DEVELOPPEMENT

ONE UNITED NATIONS PLAZA
NEW YORK, N.Y. 10017

CABLE ADDRESS: UNDEVPRO • NEW YORK

TELEPHONE: 905-5000

REFERENCE: SRL/GEN

3 May 1985

Dear Mr. Miles,

Further to our telephone conversation on 2 May I enclose a copy of a list of the UNDP Projects which are currently under way, and those which are expected to start within our country programme period (1984-1986) for Sri Lanka. The list is divided into two parts, the first part being planned projects which are currently under way, and the second part being pipeline projects which are expected to start through the present country programme cycle. In the latter case the identification of UN Executing Agencies is only tentative. More information about the orientation of UNDP's cooperation with Sri Lanka can be found in the Country Programme document, of which I enclose an extra copy in case you have not already seen it. Please let me know if I can be of any further help.

Yours sincerely,

A handwritten signature in cursive script, appearing to read "Richard Millar".

Richard Millar
Area Officer, Division I
Regional Bureau for Asia and the Pacific

Mr. Henry Miles
8302 West Blvd. Drive
Alexandria
Virginia 22308

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UNDP Projects in Sri Lanka

<u>Number</u>	<u>Title</u>	<u>Executing Agency</u>	<u>UNDP Contribution</u> \$
(a)	<u>Approved Projects:</u>		
SRL/83/005	Development Planning, Phase II	UN Department of Technical Cooperation for Development	562,000
SRL/83/021	National Statistical System, Phase II	" " "	368,000
SRL/79/037	Apprenticeship Training	International Labour Organization	780,000
SRL/82/005	Labour Market Information	" " "	78,000
SRL/82/009	Vocational Skills	" " "	726,000
SRL/83/023	National Institute of Business Management Computer Course	" " "	13,000
SRL/84/038	Public Enterprise Management	" " "	22,000
SRL/84/040	Assistance to the Sri Lanka National Design Centre	International Labour Organization/ Food and Agriculture Organization of the United Nations	1,000
SRL/79/014	Forest Inventory	Food and Agriculture Organization of the United Nations	732,000
SRL/79/023	Aquaculture	" " "	749,000
SRL/79/058	Land Use Planning	" " "	280,000
SRL/81/011	Mahaweli System B Farm	" " "	496,000
SRL/81/015	Sericulture	" " "	646,000
SRL/81/016	Feed Resources Inventory	" " "	77,000
SRL/82/002	Roots and Tuber Crops	" " "	306,000
SRL/84/006	Plantation Management	" " "	171,000
SRL/84/010	Tea Smallholders	" " "	35,000

<u>Number</u>	<u>Title</u>	<u>Executing Agency</u>	<u>UNDP Contribution</u> \$
<u>Approved Projects (Contd.)</u>			
SRL/84/012	Development of Palmyrah Industry	Food and Agriculture Organization	1,000
SRL/84/013	Horticulture, Phase II	Food and Agriculture Organization of the United Nations	144,000
SRL/79/046	Environmental Protection	United Nations Educational, Scientific and Cultural Organization	111,000
SRL/81/005	Education Quality Improvement	" " "	800,000
SRL/81/013	Technical Teacher Training College	United Nations Educational, Scientific and Cultural Organization/World Health Organization	847,000
SRL/84/008	Aquatic Research	" " "	303,000
SRL/84/022	Open University, Phase II	" " "	1,055,000
SRL/84/001	Water Supply Board, Phase II	World Health Organization	75,000
SRL/84/020	Traditional Medicine	" " "	51,000
SRL/81/009	Civil Aviation Training Centre	International Civil Aviation Organization	769,000
SRL/83/006	Airport and Aviation Services	" " "	278,000
SRL/83/015	Telecommunications Training Centre	International Telecommunication Union	1,125,000
SRL/83/008	Short-term Consultants/Fellows	UNDP/Office for Projects Execution	262,000
SRL/83/017	Scientific Adviser to the Presidential Secretariat	" " "	91,000
SRL/84/011	Transfer of Know How through Expatriate Nationals, Phase II	" " "	138,000
SRL/84/025	Mahaweli Training	" " "	64,000

<u>Number</u>	<u>Title</u>	<u>Executing Agency</u>	<u>UNDP Contribution</u> \$
<u>Approved Projects (Contd.)</u>			
SRL/79/054	Textile Centre	United Nations Industrial Development Organization	2,385,000
SRL/81/007	Leather Products	" " "	293,000
SRL/82/003	Standards and Quality Control	" " "	689,000
SRL/82/007	Industrial Energy Conservation	" " "	375,000
SRL/83/003	Leather Industry	" " "	112,000
SRL/83/007	Mineral Sands	" " "	150,000
SRL/83/012	Energy Management	" " "	198,000
SRL/83/016	Foreign Investment Committee	" " "	150,000
SRL/83/019	Assistance to the Greater Colombo Economic Commission	" " "	332,000
SRL/84/016	Ports Authority Training	United Nations Conference on Trade and Development/International Labour Organization	390,000
SRL/81/010	Structural Engineering	United Nations Centre for Human Settlements/Habitat	180,000
SRL/84/003	Low Income Shelter	" " "	150,000
SRL/81/014	Export Development Board	International Trade Centre/United Nations Conference on Trade and Development	851,000
SRL/81/006	Mahaveli Plan Coordination	Government	682,000
SRL/82/001	Agriculture Settlements Training	Government	180,000
SRL/83/022	Solar Kiln	Government	44,000

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<u>Number</u>	<u>Title</u>	<u>Executing Agency</u>	<u>UNDP Contribution</u> \$
(b) Pipeline Projects			
SRL/83/002	Winged Bean Development Programme	Food and Agriculture Organization	122,000
SRL/84/007	Sugar Research	" " "	375,000
SRL/84/014	Rubber Research Institute	" " "	187,000
SRL/84/015	National Food Control	" " "	251,000
SRL/84/024	Rainfed Rice	" " "	753,000
SRL/84/028	Minor Export Crops, Phase IV	" " "	600,000
SRL/84/030	Roots and Tuber Crops, Phase II	" " "	217,000
SRL/84/032	Land Use Planning, Phase II	" " "	275,000
SRL/84/037	Planning and Training in Land Settlement	" " "	1,200,000
SRL/85/001	National Institute of Education	United Nations Educational, Scientific and Cultural Organization	563,000
SRL/84/019	Institute of Health Sciences	World Health Organization	312,000
SRL/84/021	Health Information System	World Health Organization	333,000
SRL/84/048	Aviation Security	International Civil Aviation Organization	306,000
SRL/84/039	Marine Engineers/Deck Officers	International Maritime Organization	487,000
SRL/84/002	Programme Logistical Support	UNDP/Office for Projects Execution	82,000
SRL/83/004	Entrepreneurship	United Nations Industrial Development Organization	250,000
SRL/83/020	Infrastructure Studies	" " "	170,000
SRL/84/045	Central Freight Bureau	United Nations Conference on Trade and Development	30,000
SRL/84/042	Low Income Shelter, Phase II	World Bank	398,000

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<u>Number</u>	<u>Title</u>	<u>Executing Agency</u>	<u>UNDP Contribution</u> \$
<u>Pipeline Projects (Contd.)</u>			
SRL/84/023	Export Development	International Trade Centre	500,000
SRL/84/005	Promotion of Technical Cooperation among Developing Countries	Government	88,000
SRL/85/004	Soyabean, Phase IV	Government	150,000

RM/myo
2.5.85

Sri Lanka - Fund Relations
(As of February 28, 1985)

I. Membership Status

- (a) Date of membership: August 29, 1950
(b) Status: Article XIV

A. Financial Relations

II. General Department (as of February 28, 1985)

- (a) Quota: SDR 223.1 million.
(b) Total Fund holdings of Sri Lanka rupees: SDR 542.14 million (243.0 percent of quota)
(c) Fund credit: SDR 325.01 million (145.67 percent of quota)
Of which:

	<u>(SDR million)</u>	<u>(Percent of quota)</u>
Buffer stock	5.2	2.3
Compensatory financing facility	31.98	14.3
Extended fund facility	237.80	106.6
Credit tranche purchases		
Ordinary resources	32.8	14.7
Enlarged access resources	17.2	7.7
(d) Reserve tranche position:	SDR 5.98 million.	2.7

III. Current and Previous Arrangements and Special Facilities

- (a) Current stand-by arrangement: None.
- (b) Previous stand-by and extended arrangements during the past 10 years.
1. November 22, 1977-November 22, 1978: Stand-by arrangement
Amount: SDR 93.0 million; 94.9 percent of quota (full amount purchased).
 2. January 1, 1979-December 31, 1981: Extended fund arrangement
Amount: SDR 260.3 million; 218.7 percent of quota, of which: SDR 80 million purchased in 1979; SDR 30 million purchased in 1980; SDR 150.3 million purchased in 1981.
 3. September 4, 1983-July 31, 1984: Stand-by arrangement.
Amount: SDR 100 million; 44.8 percent of quota, of which: SDR 30 million purchased in 1983 and SDR 20 million purchased in 1984; the balance of SDR 50 million was undrawn after the arrangement was interrupted in January 1984.

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ASIA DEVELOPMENT

II. BANK OPERATIONS IN SRI LANKA

A. Bank Operations (1968-1983)

27. Bank operations in Sri Lanka started in 1968. The Bank has so far provided 37 loans ^{1/} amounting to \$411.76 million for 31 projects. Of these, six loans amounting to \$14.14 million were from ordinary capital resources and 31 loans, amounting to \$397.62 million, were from Special Funds. To help mobilize a larger inflow of external assistance to meet the country's development needs, the Bank has promoted co-financing arrangements totalling about \$230.10 million with a number of bilateral and multilateral sources ^{2/} for 10 projects.

28. The principal sectors assisted by the Bank are set out in Table 1 below.

Table 1: Sectoral Allocation of Bank-Assisted
Loan Projects in Sri Lanka
(As of 30 November 1984)

Sector	Amount (\$ million)	Per Cent
Agriculture	294.47	71.5
Energy	40.25	9.8
Industry and Development Banks	30.11	7.3
Transportation/Communications	21.51	5.2
Education	16.11	3.9
Health	9.31	2.3
Total	<u>411.76</u>	<u>100.0</u>

Consistent with the Government's priorities and the development needs of Sri Lanka, the Bank has placed particular emphasis on developing a program in the agriculture sector. The Bank has so far provided 19 loans for agriculture, of which six have been for irrigation, six for agro-industries, three for fisheries and the remaining for rural credit, coconut development, livestock and forestry.

^{1/} Including two loans for one project, four supplementary loans for four projects and one "special assistance" supplementary loan for five ongoing projects.

^{2/} Federal Republic of Germany, India, Kuwait, the Netherlands, Sweden, Overseas Development Authority of the United Kingdom, International Development Association (IDA), OPEC Fund for International Development, International Fund for Agricultural Development (IFAD), and United Nations Development Programme (UNDP).

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29. As of 30 November 1984, the Bank had provided technical assistance totalling \$5.485 million, including \$1.77 million financed by EEC, the Government of Switzerland and IFAD, for 35 projects of which 18 have so far resulted in Bank loans amounting to \$262.3 million. The principal sectors assisted by the Bank are set out in Table 2 below.

Table 2: Sectoral Allocation of Bank-Assisted Technical Assistance Projects in Sri Lanka
(As of 30 November 1984)

Sector	Amount (\$ million)	Per Cent
Agriculture	3.590	65.5
Energy	0.704	12.8
Industry and Development Banks	0.693	12.6
Education	0.150	2.7
Transport and Communications	<u>0.348</u>	<u>6.4</u>
Total	<u>5.485</u>	<u>100.0</u>

Of the 35 projects for which the Bank has provided technical assistance, ten were advisory and operational, 24 were project preparatory, and one was both advisory and operational as well as project preparatory.

30. Of the 31 projects assisted by the Bank, 12 have been substantially completed and the loans closed. Implementation of five ongoing projects has tended to lag from schedule ^{1/}. The reasons for delay include inadequate allocation of budgetary resources and delays in achieving loan effectiveness, appointing project staff and recruiting consultants. Underlying these factors is the strain imposed on the Government's limited financial, institutional and trained manpower resources imposed by the large investment outlays of recent years (particularly on AMDP). Individual problems as they arise have been brought to the notice of the Government by project review missions and appropriate assurances have been obtained on the steps needed to minimize further delays. Project implementation continues to be closely monitored by the Bank.

^{1/} These are Kirindi Oya Irrigation and Settlement (Loan No. 324 approved on 9 Dec. 1977 and Supplementary Loan No. 612 approved on 9 Dec. 1982); Sevanagala Sugar Development (Loan No. 369 approved on 29 Nov. 1978); Rural Credit (Loan No. 432 approved on 6 Dec. 1979); Mahaweli Area Roads (Loan No. 471 approved on 30 Sept. 1980); and Anuradhapura Dry Zone Agriculture (Loan No. 496 approved on 15 Dec. 1980).

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31. Sri Lanka's implementation record compares well with that of other major Special Funds borrowers. Loan disbursements, at 43.3 per cent of the total Special Funds amount available for withdrawal as of 30 September 1984, exceed the comparable percentage for Bank-wide Special Funds (38.8 per cent). OCR loan amounts have been fully disbursed. From 1986 onwards, the Government will be able to pay more attention to the planning and implementation of non-AMDP projects, and this should have a beneficial impact on the Bank's ongoing projects.

B. The Bank's Operational Strategy (1984-1987)

32. The Government's broad development objective since 1977 has been the establishment of an open economy resting on comparative advantage, in which export growth will be critical to the generation of resources sufficient to sustain imports, investment and growth at desirable levels. Private sector development, particularly through the generation of exports and employment, is intended to provide the major impulse behind growth 1/. In its medium-term assessment of development objectives and proposed investments 2/, the Government has drawn some important conclusions from the successes and failures of the past seven years (see paras 5-9). It has reconfirmed its basic development strategy, but wishes to bring about significant changes in emphasis. (i) There is an implicit recognition that public investment has been larger, longer in gestation and more inflationary than it should have been, and needs to be reduced (from 15 per cent of GDP in 1984 to 12 per cent in 1988), to be evaluated more fully and to generate returns more quickly. (ii) Steps are proposed to increase the availability of resources to the private sector (through enabling it to borrow from non-banking financial institutions) and to improve the export investment environment (through a tariff structure unbiased against exports). (iii) There is a realization that capital assets have deteriorated through neglect of operation and maintenance (O&M) and an intention to make specific O&M budget allocations in future 3/. (iv) Investment on AMDP is projected to decline from 43 per cent of public investment (1984) to 3.5 per cent (1988), releasing larger resources for neglected sectors, systematic investment planning for some of which has already commenced.

33. The Bank considers appropriate both the broad development objectives of the Government and the medium-term macroeconomic adjustments it has proposed. The Bank shares the Government's belief that, with one major exception (tree crop plantations), infrastructure

1/ The Government has recently decided that no project will be undertaken by the public sector if it can be better handled by the private sector. Public investment is viewed basically as a means of providing infrastructure facilities necessary to support private entrepreneurship.

2/ Public Investment 1984-1988 (Ministry of Finance and Planning, May 1984).

3/ O&M needs will in fact receive higher priority than new projects.

development should remain the focus of the public investment program. The Bank has identified certain priority criteria against which it will test alternative project proposals.

34. First, high priority attaches to reversal of the trend towards deterioration of capital assets. This is particularly true of the tree crop (tea, rubber and coconuts) sector, whose rehabilitation provides the most viable medium-term means of rectifying the export weakness of Sri Lanka's external account. Other affected sectors include irrigation, power distribution and roads. The Bank has recently approved or is considering projects in all these sectors, and will seek to improve resource use efficiency through a mix of physical rehabilitation and institutional development (particularly of O&M) in a more productive policy environment.
35. Second, equal priority will attach to certain structural adjustments needed in the economy. In agriculture, there is a requirement for crop diversification now that rice self-sufficiency is in sight. Subsidiary crops need the mix of production incentives and institutional support that has enhanced paddy productivity. Large-scale hydropower potential is approaching exhaustion and there is a need for investment in thermal generation, to stabilize base load requirements and to replace existing uneconomic plants. Energy conservation is important in an economy dependent on imports for much of its commercial energy. Projects to assist these adjustments are in the Bank's pipeline. On a longer perspective, the Bank is considering how best it can assist the difficult transition to a private sector/export-oriented economy, which lies at the core of the Government's development strategy.
36. An underlying theme of the Bank's future assistance is the concern to improve the structure of Sri Lanka's external account. The Government's development strategy is critically dependent on increasing export earnings, and lack of progress in achieving that objective has been one of its major disappointments. Export promotion (tree crops, minor export crops) or import substitution (coal-based for oil-based energy, paddy production) constitute important components of a number of the Bank's pipeline projects.
37. Finally, the Bank will maintain its support of human resource development and the meeting of basic needs (health, education and water supply) at a level compatible with absorptive capacity in the social sector.
38. The Bank's endeavor will be to give its projects a sector or subsector development focus whenever feasible through adoption of the sector lending modality. This will make possible a dialogue on sector institutions and policies and so lead to adjustments of a kind that will strengthen the prospects of many pipeline projects.

STATUS OF IBRD/IDA PROJECTS IN EXECUTION
(As of March 31, 1985)

SRI LANKA

SRI LANKA

Cr. No. 701 Mahaweli Ganga Development II Project; US\$19.0 Million Credit of June 27, 1977; Effective Date: December 29, 1977; Closing Date: June 30, 1985

Construction of irrigation infrastructure and settlement are almost complete. System H has become an important contributor to national rice production, and output of other field crops is steadily increasing. Attention will need to be given to the further development of settler communities to ensure that improvement of incomes and living standards will be sustained and be shared equitably by all. Also, canal lining needs to be continued and on-farm water management given increased attention for the project to reach its full potential. An extension of the closing date from June 30, 1984 to June 30, 1985 was given to complete remaining items of construction work. The project is expected to exceed agricultural targets as projected in the SAR.

Cr. No. 818 Tree Crop Rehabilitation (Tea) Project; US\$21.0 Million of July 12, 1978; Effective Date: December 28, 1978; Closing Date: December 31, 1985

Field development is complete and estate standards are high. Estate factory rehabilitation is almost complete but there have been some problems with quality and timeliness of factory equipment supply; this requires careful monitoring. Performance on the housing component has improved but completion of physical targets will not be possible by the closing date. Private factory owners, unlike those in the low country participating under Cr. 1240-CE, have shown little initiative in arranging security to enable them to participate in the credit program; this component is unlikely to be completed. Submission of accounts has been brought up to date. Audit reports are being produced. Plans for production of a Completion Report are in hand.

Cr. No. 891 Kurunegala Rural Development Project; US\$20 Million Credit of April 26, 1979; Effective Date: August 27, 1979; Closing Date: June 30, 1985

In October 1983, IDA granted a one-year extension of the project from June 30, 1984 to June 30, 1985, with a possible extension of a further year, to enable project objectives to be achieved in the still on-going components: irrigation, coconut development, and farm credit. Other components - including agricultural extension, input supply, livestock, rural roads and water supplies, electrification, health, and education - have been completed or are near completion. The Government has requested a second extension of the project from June 30, 1985 to June 30, 1986, which is currently under consideration. If granted, it is estimated that by June 30, 1986, project investments would amount to Rs 510 million, compared to the appraisal project cost of Rs 465 million.

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Cr. No. 900 Road Maintenance Project; US\$16.5 Million of June 22, 1979; Effective Date: December 19, 1979; Closing Date: June 30, 1985

Project implementation is progressing well, and the project is expected to be completed by the current closing date.

Cr. No. 931 Agricultural Extension and Adaptive Research Project; US\$15.5 Million Credit of July 24, 1979; Effective Date: October 4, 1979; Closing Date: June 30, 1985

The basic components of the T&V extension system have been in place for some time and the Department of Agriculture (DOA) has been making sustained efforts in implementing the project. Major implementation constraints continue to be shortage of experienced and qualified middle and lower level staff, particularly of Subject Matter Officers, inadequate monitoring and supervision by the DOA headquarters staff, insufficient budgetary support, and staff shortages at the research stations. Procurement of vehicles and equipment, and civil works are proceeding satisfactorily. Overseas training under the technical assistance program is well underway.

Cr. No. 942 Small and Medium Industries Project; US\$16.0 Million Credit of July 24, 1979; Effective Date: October 23, 1979; Closing Date: June 30, 1985

The subloan component of US\$12 million has been fully committed. About US\$0.7 million remain undisbursed for technical assistance services but full disbursement is expected by June 1985. Collection has averaged 65% but portfolio arrears are increasing. Banks have increased staff at branch level to arrest increasing arrears. The technical assistance components have been streamlined and their completion is expected by the current closing date.

Cr. No. 979 Mahaweli Ganga Technical Assistance Project; US\$3.0 Million Credit of April 16, 1980; Effective Date: July 7, 1980; Closing Date: September 30, 1985

Studies and designs carried out under the EEC Special Action Credit have been completed. The Transbasin Diversion Study, financed under the IDA credit, also has been completed and the draft final report (scheduled for July 1984) detailing the consultant's findings has not yet been received. About US\$0.4 million of the EEC Special Action Credit and US\$1.4 million of the IDA Credit have not yet been utilized. A Government request to utilize funds to finance consultants for the recently approved Mahaweli IV project, due to delays in approval of the Saudi Development Fund loan which was to finance these consultants, was approved on October 23, 1984. A nine-month extension of the credit was granted for this purpose, extending the credit closing date to September 30, 1985. The appointment of the consultants is expected soon.

Cr. No. 994 Road Passenger Transport Project; US\$53.0 Million of April 16, 1980; Effective Date: October 27, 1980; Closing Date: September 30, 1985

Project completion is now expected by September 30, 1985, over two years behind the original schedule due to lack of management continuity in the implementing agency and slow progress in procurement procedures. Management stability has now been restored, project execution reorganized, and project implementation can be rated as satisfactory.

Cr. No. 1017 Smallholder Rubber Rehabilitation Project; US\$16.0 Million Credit of June 24, 1980; Effective Date: September 10, 1980; Closing Date: June 30, 1986

The project is behind schedule with regard to its replanting targets because of weather conditions in 1983, land ownership disputes and absentee ownership. The civil works program and procurement of motor vehicles and equipment is nearing completion. The staff situation has improved.

Cr. No. 1020 Telecommunications Project; US\$30.0 Million of June 24, 1980; Effective Date: September 10, 1980; Closing Date: June 30, 1985

All major works under the project are expected to be completed by September 1985. Some minor works would extend into 1986. The credit, however, is expected to be fully disbursed by end December 1985. Sri Lanka Telephone Department's (SLTD) financial performance is satisfactory.

Cr. No. 1041 Water Supply and Sewerage II Project; US\$30.0 Million of September 24, 1980; Effective Date: February 26, 1981; Closing Date: September 30, 1985

Project implementation, which has sustained some delay, has been rescheduled to reflect availability of counterpart funds. Financial performance covenants have not been met, but Government is actively pursuing a financial recovery program in consultation with IDA to redress the situation.

Cr. No. 1048 Sixth Power Project; US\$19.5 Million Credit of September 24, 1980; Effective Date: March 30, 1981; Original Closing Date: March 31, 1985, Current Closing Date: March 31, 1986

The project started very slowly because of delays in arranging cofinancing with Saudi Fund and Ceylon Electricity Board's (CEB) very slow procurement procedures, but is now progressing satisfactorily. The Government of Sri Lanka (GOSL) requested an extension of the closing date to 12/31/86, and IDA agreed to an extension to 3/31/86. The main sector problem is weak CEB management, principally due to its inability to retain experienced staff as a result of GOSL imposed conditions of service which force CEB to pay uncompetitive salaries. This is a public sector issue.

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Cr. No. 1079 Second Rural Development Project; US\$33.5 Million Credit of February 2, 1981; Effective Date: June 2, 1981; Closing Date: June 30, 1986

Most project components are progressing according to schedule, as revised after the 1980 and 1981 budget cuts. Construction of buildings and procurement were essentially completed by end 1983. Rehabilitation of irrigation systems is being implemented satisfactorily, with improved water management practices being introduced systematically in all rehabilitated schemes. The forestry development program in Matale is still significantly behind schedule, although there has been some recent improvement. The use of agricultural credit also has been much below expectation, and steps taken to accelerate implementation of this component have not yet taken effect.

Cr. No. 1130 Construction Industry Project; US\$13.5 Million Credit of June 1, 1981; Effective Date: September 19, 1981; Closing Date: December 31, 1985

The Project continues to show progress and is expanding into new areas such as highway sector training and manpower development for the Government's housing program. Output of the different training courses is close to appraisal target. An issue is the loss of instructors but a new instructor training program is now underway to overcome this problem.

Cr. No. 1160 Village Irrigation Rehabilitation Project; US\$30.0 Million Credit of July 15, 1981; Effective Date: September 24, 1981; Closing Date: December 31, 1986

The rate of project implementation is steadily increasing after a slow initial start, but is still substantially below projections in the SAR. The quality of construction work is generally satisfactory. While the phasing of downstream development has much improved, problems have been encountered in land alienation and in Department of Agrarian Services (DAS) taking over completed schemes from the Irrigation Department (ID). The DAS water management program is proceeding well in most districts and is beginning to have an impact on farmer activities and agricultural production. Nevertheless, the program has fallen behind the SAR targets, due to initial build-up problems, exclusion of certain districts, political disturbances, and budgetary constraints.

Cr. No. 1166 Mahaweli Ganga Development Project III; US\$90.0 Million Credit of November 5, 1981; Effectiveness Date: February 8, 1982; Closing Date: December 31, 1987

The Minipe Right Bank Transbasin Canal was completed in 1984 and is now in operation. Construction of the main and branch canals for zones 3 to 6 is progressing well, although this work was delayed by about six months mainly due to severe and unprecedented monsoon rains during December 1983 -

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March 1984. On-farm development works for Zone 3 have been completed and are progressing well in Blocks 401, 402, 403 and 411 of Zone 4. Zone 3 is receiving irrigation water during the current maha 84/85 season. Procurement of equipment is proceeding satisfactorily and there are no major problems. It is expected that project completion will be delayed by about one year.

Cr. No. 1182 Second Small and Medium Industries Project; US\$30.0 Million of February 5, 1982; Effective Date: May 5, 1982; Closing Date: December 31, 1985

The objectives of this project are to further develop the term financing and extension service capabilities established under SMI I (Cr. 942-CE). Progress is considerably slower than that estimated at the time of appraisal. After three years of effectiveness, only 10% of the subloan component has been utilized. This is due in part to the impact of the worldwide economic recession during FY82-FY83, and the ethnic disturbances which have continued since July 1983 and which have significantly constrained new industrial investment. An intensive ongoing project promotion program initiated in February 1984 has improved utilization of credit funds. The technical assistance components of the project are proceeding satisfactorily.

Cr. No. 1210 Seventh (Mahaweli Transmission) Power Project; US\$36.0 Million Credit of April 8, 1982; Effective Date: July 23, 1982; Original Closing Date: May 31, 1985, Current Closing Date: May 31, 1986

The project started slowly because of poor performance of the contractor for the transmission lines, and was further delayed when the contractor abandoned the work after serious ethnic riots had broken out in mid-1983. The contract had to be renegotiated with another contractor. The project is now moving fairly well but commissioning will be late. The closing date has been extended to March 31, 1986.

Cr. No. 1240 Tea Rehabilitation and Diversification Project; US\$20 Million Credit of June 28, 1982; Effective Date: November 12, 1982; Closing Date: September 30, 1986

Overall the performance of project management is good and the status of the project is satisfactory. Rehabilitation of tea is almost complete and targets have been met or exceeded. Diversification is somewhat slow because of the prior need to establish shade and support for the diversification crops. The performance of suppliers of factory equipment will need careful watching, with regard to both quality and timing. Progress on housing has improved and substantial completion of this component should be possible by the closing date. Procurement of vehicles is complete. Social welfare and medical programs are satisfactory.

1240

Cr. No. 1317 Forest Resources Development Project; US\$9 Million Credit of February 2, 1983; Effective Date: November 28, 1983; Closing Date: December 31, 1989

Progress is good. Consultants continue their work and the preparation of the master plan and the plantation programs are on schedule. Procurements proceed on schedule and disbursements are somewhat behind appraisal estimates but are expected to improve. The University course has started as planned and student enrolment is satisfactory. The staffing of some middle and lower level positions is still behind schedule and may affect project implementation if no solution is found.

Cr. No. 1363 Third Rural Development Project; US\$23.0 Million Credit of June 20, 1983; Effective Date: November 3, 1983; Closing Date: September 30, 1989

Good progress is being made in most components but the work programs of several implementing agencies are behind schedule, partly because of unusual weather conditions experienced in early 1984 and also because of security problems due to recent disturbances. Procurement and building construction are proceeding at a good pace, however, and project expenditures for 1984 slightly exceeded budgetary allocations. Agricultural programs are gradually gaining momentum, and it is expected that with the appointment of staff to additional posts approved by Treasury, earlier delays in project implementation gradually will be made up.

Cr. No. 1401 Industrial Development Project; US\$25.0 Million Credit of October 12, 1983; Effective Date: January 5, 1984; Closing Date: June 30, 1986

The subloan component is progressing satisfactorily with project commitments of 70% and disbursements 22% as of March 31, 1985. With a healthy project pipeline, the subloan component is expected to be fully committed ahead of schedule. Use of the US\$2.0 million technical assistance component for improving the efficiency of public sector enterprises is behind schedule because of delays in locating and hiring consultants, a reduced Government commitment to implementing public sector improvement programs and frequent change in public sector management. IDA review missions have been scheduled to follow-up on this component.

Ln. No. 2187 Eight Power (Diesel) Project; US\$42.7 Million Loan of August 18, 1982; Effective Date: November 11, 1982; Original Closing Date: March 31, 1985, Current Closing Date: March 31, 1986

All four generators have now been commissioned, about seven months behind original schedule. The delay was due to slow procurement procedures and challenges to contract award by unsuccessful bidders. Because some work

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Cr. No. 1416

Technical Assistance Project; US\$3.0 Million Credit of February 29, 1984; Effective Date: April 20, 1984; Closing Date: December 31, 1987

Subprojects approved are: establishment of the Technical Assistance Coordination Cell and telex facilities. The latter is to provide telex equipment in conjunction with the microwave communication system provided by the Government of India. Several subprojects identified to strengthen planning and project preparation have been financed by bilateral sources.

Cr. No. 1460

Forestry Development Project; US\$5.50 Credit of June 25, 1984; Effective Date: September 27, 1984; Closing Date: September 30, 1990

Project implementation is progressing in all project components. Targets for the first year are relatively modest and should be achieved. Government funding for civil works is being arranged and construction of roads and nurseries, staff recruitment and procurement has started.

U.S. ECONOMIC ASSISTANCE FOR SRI LANKA
FY 1976-FY 1986

	PLAN	OBS THRU FY 83	FY 84 Actual	FY 85 CP	FY 85 OVB	FY 86 CP	MORT- GAGE
DEVELOPMENT ASSISTANCE.							
0040 Rice Research	loan	3,700	3,700				
0041 Paddy Storage	loan	4,775	4,775				
0042 Mahaweli Ganga	grant	634	634				
	loan	4,432	4,432				
0044 Dev Svcs & Trng.	grant	6,500	5,700				
0045 Ag. Base Mapping	loan	3,863	3,863	800			
0049 Ag. Education Dev.	grant	7,500	7,500				
0051 Ag. Inputs	loan	30,436	30,436				
0055 Reforestation &	grant	1,450	1,250				
	loan	9,000	6,843		200	200	
0056 Mahaweli Bas Dev I	loan	10,000	10,000		2,157	2,157	
0057 Water Management	grant	5,100	3,600	1,500			
	loan	10,800	10,800				
0058 Diversified Ag.	grant	7,900	790				
	loan	3,500	1,960	1,750	3,040	1,460	2,610
0060 FVO Co-Financing	grant	2,500	900	200	1,540		
0073 Mahaweli Basin	grant	3,000	1,000	402	402	498	500
	loan	107,000	68,000	1,000	1,000	2,000	
0075 Mahaweli Environ.	grant	5,000	1,500	3,500	15,041	11,706	
0078 Mahaweli Sector Sp	loan	50,000	50,000				
0080 Irrigation	grant	5,000					
	loan	14,000			1,500		
0082 Pvt Enterprise Dev	grant	1,500	1,500		2,750		
0083 Ag Planning & Svcs	grant	4,000				10,000	4,000
	loan	3,000				1,000	3,000
0085 Dev. Trng & Spt.	grant	9,000					3,000
0086 Mahaweli Agr.	grant	4,500			1,000	500	7,500
	loan	36,700				960	1,490
				6,000	3,710	10,533	22,457
ARDN							
	TOTAL	354,790	215,433	37,044	22,600	26,215	28,041
	grant	(63,584)	(22,584)	(7,790)	(5,852)	(7,102)	(7,508)
	loan	(291,206)	(192,849)	(29,254)	(26,748)	(19,113)	(20,533)
0043 Malacia Control	grant	4,000		1,000	2,000	2,000	1,000
	loan	26,000	20,852	3,148	1,000	2,000	
0060 FVO Co-Financing	grant	1,224	724	100			
0062 Inst. of Hlth Sci.	grant	2,200	2,200		100	100	200
0063 Market Town	grant	2,000	2,000				
	loan	6,000	6,000				
0081 Preventive Health	grant	5,000					
& Pop Services					1,000		
0088 Water Supply &	grant	5,000		500	1,000	2,000	1,500
	loan	7,300		2,300	2,100	4,100	900
							1,000
HE							
	TOTAL	58,724	31,776	7,048	7,200	10,200	3,500
	grant	(19,424)	(4,924)	(1,600)	(4,100)	(4,100)	(2,600)
	loan	(39,300)	(26,852)	(5,448)	(3,100)	(6,100)	(1,200)
0081 Preventive Health	grant	5,000			1,000		
& Pop Services							
POP							
	TOTAL	5,000			1,000		
	grant	5,000			(1,000)		
0060 FVO Co-Financing	grant	959	516	143	200	200	100
PR							
	TOTAL	959	516	143	200	200	100
	grant	(959)	(516)	(143)	(200)	(200)	(100)
0060 FVO Co-Financing	grant	1,800	300	500	500	250	359
0082 Private Enterprise	grant	1,500	1,500				
Promotion	loan	1,000	1,000				
SDF							
	TOTAL	4,300	2,800	500	500	250	359
	grant	(3,300)	(1,800)	(500)	(500)	(250)	(359)
	loan	(1,000)	(1,000)				(391)
TOTAL DEVELOPMENT ASSISTANCE							
	TOTAL	423,773	250,525	44,735	41,500	36,865	32,000
	Grant	(92,267)	(29,824)	(10,033)	(11,652)	(11,652)	(10,567)
	Loan	(331,506)	(220,701)	(34,702)	(29,848)	(25,213)	(21,433)
PL 480 FOOD AID							
	TOTAL		30,031	30,396	29,855	29,716	29,716
Title I	loan		25,000	26,000	26,000	26,000	26,000
Title II (VOLAG)	grant		5,031	6,114	3,855	3,716	3,716
TOTAL DEVELOPMENT & FOOD ASSISTANCE							
			74,766	77,836	66,720	61,716	
HOUSING GUARANTY							
	(100,000)	(35,000)		(15,000)	(25,000)		(25,000)
PEACE CORPS (Non-Add)							
		40	260		340	330	

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BASIC DATA

TOTAL POPULATION.. (THOUSANDS, MID 1984)	15,925
PER CAPITA GNP..... (DOLLARS, 1962)	320
ANNUAL PER CAPITA REAL GNP GROWTH RATE.. (1960-82)	2.6%
ANNUAL RATE OF INFLATION (1970-82)	13.3%
NATIONAL INCOME RECEIVED BY LOW 20% OF POPULATION.. (1979)	3.8%
LIFE EXPECTANCY AT BIRTH, IN YEARS	
(1984) TOTAL 68.9 MALE 67.0 FEMALE 70.9	
(1970) TOTAL 63.6 MALE 62.5 FEMALE 64.8	
ADULT LITERACY RATE (1981) TOTAL 86% MALE 91% FEMALE 81%	

AGRICULTURE

ANNUAL PER CAPITA AGRICULTURAL PRODUCTION GROWTH RATE (1974 -1983)	0.4%
AGRICULTURAL PRODUCTION AS % OF GDP..... (1983)	28%
POPULATION DENSITY / SQ KM OF AGRICULTURAL LAND (1979)	763
MAJOR CROP(S)	
SUBSISTENCE: RICE	ARABLE LAND YEAR
CASH: TEA ,RUBBER ,COCONUTS	48% (1983)
	35% (1983)
MAJOR AGRICULTURAL EXPORTS: (1983) TEA ,RUBBER ,COCONUTS	
MAJOR AGRICULTURAL IMPORTS: (1983) WHEAT ,RICE ..	
PROPORTION OF LABOR FORCE IN AGRICULTURE..... (1981)	45%

CENTRAL GOVERNMENT FINANCES

TOTAL REVENUES AND GRANTS (\$ MILLIONS, U.S.)	
(1978) 763 (79) 870 (80)	974
TOTAL EXPENDITURES AND NET LENDING (\$ MILLIONS, U.S.)	
(1978) 1,102 (79) 1,275 (80)	1,711
DEFICIT(-) OR SURPLUS (\$ MILLIONS, U.S.)	
(1978) -339 (79) -405 (80)	-737
DEFENSE EXPENDITURES,	
AS % OF TOTAL EXPENDITURES.. (1975) 2.8% (76) 2.2% (77) 2.7%	
AS % OF GNP..... (1975) 0.7% (76) 0.6% (77) 0.6%	
OFFICIAL INTERNATIONAL RESERVES, GROSS HOLDINGS END OF PERIOD, (\$MILLIONS, U.S.) (1980) 249 (81) 330 (82) 354	
EQUIVALENT TO 1.6 MONTHS OF IMPORTS (1982)	

FOREIGN TRADE

MAJOR EXPORTS (1982)	TEA	RUBBER	PETROLEUM PROD
EXPORTS TO U.S.			
(\$ MILLIONS, US, FOB) (1981)	143	(1982) 143	(1983) 181
AS % OF TOTAL EXPORTS (1980)	14% (1981)	16% (1982)	16%
MAJOR IMPORTS (1982)	PETROLEUM	MACHINERY	TRANSP. EQ
IMPORTS FROM U.S.			
(\$ MILLIONS, US, CIF) (1981)	128	(1982) 115	(1983) 102
AS % OF TOTAL IMPORTS (1980)	6% (1981)	9% (1982)	7%
TRADE BALANCE (\$ MILLIONS, U.S.) (1980)	-602 (81)	-533 (82)	-709
TRADING PARTNERS:	JAPAN	UNITED STATES	SINGAPORE
EXTERNAL PUBLIC DEBT AS % OF GNP (1981)	71.0%		
SERVICE PAYMENTS ON EXTERNAL PUBLIC DEBT, (\$ MILLIONS, U.S.)		(1982) 135	
AS % OF EXPORT EARNINGS (DEBT SERVICE RATIO).... (1982)		13.3%	

SOCIAL DATA

POPULATION GROWTH RATE... (1970)	1.9% (1978)	1.8% (1984)	1.8%
POPULATION IN URBAN AREAS..... (1970)	22%	(1984)	28%
LIVE BIRTHS PER 1,000 POPULATION..... (1970)	30	(1984)	28
MARRIED WOMEN AGED 15-44 YRS. USING CONTRACEPTION. (1982)	54.9%		
POPULATION (1984) IN AGE GROUP:			
(0-14YRS) 34.1%	(15-64YRS) 61.6%	(65+ YRS) 4.4%	
INFANT DEATHS IN FIRST YR OF LIFE PER 1000 LIVE BIRTHS (1984)	31		
PEOPLE PER PHYSICIAN..... (1980)	7,172		
MAJOR CAUSES OF DISEASE (1979) UNKNOWN AILMENTS, FLU & PNEUMONIA , MALARIA			
DEATH.. (1981) FLU & PNEUMONIA , DEFICIENT DIET , UNKNOWN AILMENTS			
PER CAPITA CALORIE SUPPLY AS A % OF REQUIREMENTS.. (1977)	93%		
POPULATION WITH REASONABLE ACCESS TO SAFE WATER SUPPLY (1976)	20%		
TOTAL SCHOOL ENROLLMENT AS RATIO OF POPULATION IN AGE GROUP:			
PRIMARY..... (1981) TOTAL 100 MALE 103 FEMALE 97.2			
SECONDARY..... (1976) TOTAL 54.7 MALE 50.0 FEMALE 63.8			
POST SECONDARY.. (1980) TOTAL 2.3 MALE 2.6 FEMALE 2.0			
ENERGY PRODUCTION AS % OF CONSUMPTION..... (1982)	10.7%		

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U.S. OVERSEAS LOANS AND GRANTS - OBLIGATIONS AND LOAN AUTHORIZATIONS
(U.S. Fiscal Years - Millions of Dollars)

ECONOMIC PROGRAMS OF ALL DONORS
(Millions of Dollars)

COUNTRY SRI LANKA

A. ASSISTANCE FROM INTERNATIONAL AGENCIES - COMMITMENTS

PROGRAM	FOREIGN ASSISTANCE ACT PERIOD					TOTAL LOANS AND GRANTS 1946-83	REPAY- MENTS AND INTEREST 1946-83	TOTAL LESS REPAY- MENTS AND INTEREST 1946-83
	1979	1980	1981	1982	1983			
I. ECONOMIC ASSISTANCE - TOTAL	49.9	60.3	70.8	70.8	80.4	725.2	105.1	620.1
Loans	39.7	49.6	61.1	58.7	66.9	551.7	105.1	446.6
Grants	10.2	10.7	9.7	12.1	13.5	173.5	-	173.5
a. A.I.D. and Predecessor Agencies	29.0	31.4	46.1	48.5	50.7	301.0	26.9	274.2
Loans	23.4	25.8	43.8	42.0	45.5	254.7	26.8	227.9
Grants	5.6	5.6	2.3	6.5	5.2	46.3	-	46.3
<i>(Economic Support Fund)</i>	-	-	-	-	-	7.2	-	-
b. Feed for Peace (PL 488)	20.9	28.9	24.7	22.3	29.7	422.6	78.3	344.3
Loans	16.3	23.8	17.3	16.7	21.4	297.0	78.3	218.7
Grants	4.6	5.1	7.4	5.6	8.3	125.6	-	125.6
Title I - Total Sales Agreements	16.3	23.8	17.3	16.7	21.4	301.9	78.3	223.6
Repayable in U.S. Dollars - Loans	16.3	23.8	17.3	16.7	21.4	293.1	65.0	218.1
Payable in Foreign Currency - Planned for Country Use	-	-	-	-	-	18.8	13.3	5.5
Title II - Total Grants	4.6	5.1	7.4	5.6	8.3	120.7	-	120.7
Emerg. Relief, Econ. Develop. & World Food Program	0.6	-	-	-	3.7	25.5	-	25.5
Voluntary Relief Agencies	4.0	5.1	7.4	5.6	4.6	95.2	-	95.2
c. Other Economic Assistance	-	-	-	-	-	1.6	-	1.6
Loans	-	-	-	-	-	-	-	-
Grants	-	-	-	-	-	1.6	-	1.6
Peace Corps	-	-	-	-	-	-	-	-
Narcotics	-	-	-	-	-	1.6	-	1.6
Other	-	-	-	-	-	1.6	-	1.6
MILITARY ASSISTANCE - TOTAL	-	-	-	-	-	-	-	-
Credits or Loans	*	*	0.1	2.1	0.1	6.1	0.4	5.7
Grants	*	*	-	2.0	-	2.3	0.4	1.9
a. MAP Grants	-	-	0.1	0.1	0.1	3.8	-	3.8
b. Credit Financing - FMS	-	-	-	-	-	3.2	-	3.2
c. Military Assistance Service-Funded (MASF) Grants	-	-	-	2.0	-	2.3	0.4	1.9
d. Transfers from Excess Stocks	*	*	0.1	0.1	0.1	0.6	-	0.6
e. Other Grants	-	-	-	-	-	-	-	-
TOTAL ECONOMIC AND MILITARY ASSISTANCE	49.9	60.3	70.9	72.9	80.5	731.3	105.5	625.8
Loans	39.7	49.6	61.1	60.7	66.9	554.0	105.5	448.5
Grants	10.2	10.7	9.8	12.2	13.6	177.3	-	177.3
for U.S. Government Loans and Grants	-	-	0.3	11.3	-	29.8	21.5	8.3
a. Export-Import Bank Loans	-	-	-	11.3	-	14.6	4.6	10.0
b. All Other Loans	-	-	0.3	-	-	15.2	16.9	1.7

* LESS THAN \$50,000.

	FY 1982	FY 1983	FY 1984	FY 1946-84
TOTAL	169.9	86.2	87.9	1312.7
IBRD	-2.7	0.0	12.1	129.2
IFC	2.0	7.4	0.1	39.5
IDA	36.0	32.0	55.0	713.3
IDB	0.0	0.0	0.0	0.0
ADB	35.4	39.8	20.7	339.9
AFDB	0.0	0.0	0.0	0.0
UNDP	3.8	3.7	0.0	70.7
OTHER-UN	0.0	3.3	0.0	21.1
EEC	0.0	0.0	0.0	0.0

B. BILATERAL OFFICIAL DEVELOPMENT ASSISTANCE

1. D.A.C. COUNTRIES (Gross Disbursements)

SRI LANKA	CY 1982	CY 1983	CY 1978-83
United States	53.0	62.0	296.0
Japan	66.4	79.1	331.7
United Kingdom	58.3	44.7	278.7
Germany, Fed. Rep.	27.1	45.9	179.4
Canada	33.7	36.5	175.6
Other	82.8	91.6	506.7
Total	321.3	359.8	1,768.1

2. O.P.E.C. COUNTRIES (Gross Disbursements)

	CY 1982	CY 1983	CY 1978-82
	1.5	N.A.	23.0

C. LOANS AND GRANTS EXTENDED BY COMMUNIST COUNTRIES

	CY 1982	CY 1983	CY 1954-83
USSR	-	-	100
Eastern Europe	-	-	93
China	Negl	-	222
Total			415

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PROGRAM SUMMARY (In thousands of dollars)								
Fiscal Year	Total	Agriculture, Rural Development and Nutrition	Population Planning	Health	Education and Human Resources Development	Selected Development Activities	Other Programs	
							ESF	Other
1984								
Loans	34,702	29,254	-	5,448	-	-	-	-
Grants	10,033	7,790	-	1,600	143	500	-	-
Total	44,735*	37,044	-	7,048	143	500	-	-
1985								
Loans	25,213	19,113	-	6,100	-	-	-	-
Grants	11,652	7,102	-	4,100	200	250	-	-
Total	36,865	26,215	-	10,200	200	250	-	-
1986								
Loans	21,433	20,533	-	900	-	-	-	-
Grants	10,567	7,508	-	2,600	100	359	-	-
Total	32,000	28,041	-	3,500	100	359	-	-

* FY 1984 totals include \$1,066,000 in reobligations.

**FY 1986
PROGRAM HIGHLIGHTS**

A.I.D.'s FY 1986 program will emphasize:

- increasing and diversifying food production, rural incomes and employment by supporting the development and rehabilitation of irrigation systems, improved water management, agricultural research on diversified crops, reforestation and the strengthening of Sri Lankan development institutions, \$27.4 million.
- improving the institutional capacity to plan and carry out programs for malaria control and water supply and sanitation as well as providing opportunities for community participation in development efforts, \$4.6 million, and
- supporting the government's agriculture, food and nutrition strategy and related policies, and providing food supplements for malnourished infants, young children and mothers, \$29.7 million in PL 480.

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RESOURCE FLOWS (In thousands of dollars)			
Program	FY 1984 (Actual)	FY 1985 (Estimated)	FY 1986 (Proposed)
Aid *			
Loans	25,353	66,184	45,076
Grants	5,829	13,821	13,311
Total AID	31,182	80,005	58,387
P.L. 480 **			
Title I (of which Title III is)	25,000	26,000	26,000
Title II	(5,031)	(3,855)	(26,000 3,716)
Total P.L. 480	30,031	29,855	29,716
Total AID and P.L. 480	61,213	109,860	88,103

* AID levels represent actual and estimated expenditures
** P.L. 480 levels represent actual and estimated value of shipments

P.L. 480 (in thousands of dollars)						
Program	FY 1984 (Actual)		FY 1985 (Estimated)		FY 1986 (Proposed)	
	MT	\$	MT	\$	MT	\$
Title I						
Wheat	173,100	25,000	163,000	26,000	167,000	26,000
Rice	-	-	-	-	-	-
Feedgrains	-	-	-	-	-	-
Vegoil	-	-	-	-	-	-
Non-food	-	-	-	-	-	-
Title I Total (of which Title III is)	173,100	25,000	163,000	26,000	167,000	26,000 (26,000)
Title II ^{1/}						
Voluntary Agencies	16,117	5,031	14,012	3,855	14,012	3,716
Government - to - Government	-	-	-	-	-	-
Title II Total	16,117	5,031	14,012	3,855	14,012	3,716
Total P.L. 480	189,217	30,031	177,012	29,855	181,012	29,716

^{1/} See main volume P.L. 480 narrative and table for breakout of the World Food Program by country

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PERSONNEL DATA			
Category	FY 1984		FY 1986
	(Actual)	FY 1985 (Estimated)	(Proposed)
U.S. National Personnel AID Direct Hire ^a PASA ^b	24 -	25 -	24 -
Total	24	25	24

^a Full time equivalent workyears of employment. Do not include HIG or excess property personnel. One work-year = 2080 hours (40 hours per week).
^b On board end of year.

PARTICIPANT TRAINING DATA						
Category *	FY 1984		FY 1985		FY 1986	
	(Actual)		(Estimated)		(Proposed)	
	Academic ^a	Technical ^b	Academic	Technical	Academic	Technical
S&T /IT Managed ^c	04	55	02	50	05	07
Contract Managed ^d	03	10	03	45	11	43
Total	7	65	5	95	16	50

^a Degree seeking participants.
^b Non-degree seeking participants (may be at universities).
^c Participants programmed by Missions and sent to S&T/IT for management.
^d Participants programmed by Missions and sent to contractors hired by Missions or AID/W offices.

***Third Country Training**

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Development Overview

For 30 years following independence in 1948, the Government of Sri Lanka (GSL) emphasized expenditures on health, education and social programs, but provided little investment in economic productivity. The policies resulted in an impressive performance in social development, with food consumption by the mid-1970s increasing to 2,200 calories per capita, and life expectancy to 68 years, while infant mortality was reduced to 42 per 1,000, and the net population growth rate to 1.9 percent. The adult literacy rate grew to 85 percent, the highest in the developing countries of Asia.

Unfortunately, these impressive gains were being undermined by a stagnant economy and deteriorating public services. Welfare-oriented policies and increased reliance upon the public sector of the economy, combined with droughts and unfavorable prices for basic exports, resulted in low gross national product (GNP) growth (2.9 percent) and even lower growth in agricultural production (2 percent). The most serious consequences were widespread unemployment (about 25 percent) and massive food deficits. Since 1977, a far-reaching program has been launched to accelerate economic growth and employment. This program is based upon the liberalization and opening of the economy. Particular attention has been given to: (1) self-sufficiency in rice production; (2) accelerating the growth of exports; (3) stabilizing the price level and growth of imports through budgetary discipline, subsidy reduction, and the encouragement of private savings and investment. From 1977 to 1982, GNP growth averaged 6.2 percent and unemployment fell to about 14 percent. Concurrently, rice production increased at an average of over 7 percent per annum, even in the face of serious droughts and floods.

For the 1984-88 planning period, the GSL remains committed to the objectives of an open economy, accelerating economic growth, and employment generation, while safeguarding the living standards of the poor. The highest priority remains the Accelerated Mahaweli Development Program to provide employment, increase food production, and expand power capacity. The plan stresses the need for operations and maintenance, and takes the position that the government will not undertake activities which could be more easily and efficiently handled by the private sector. Public investment over the next five years will concentrate on quick-yielding, production-oriented projects, essential infrastructure, and urgent needs in social services. Mahaweli expenditures are followed in importance by power, transport, plantations and field crops.

In spite of communal disturbances in 1983, economic growth for the year recorded a strong 4.9 percent. Due to high tea prices, growth in 1984 is expected to exceed 5.8 percent.

Adequate donor support is critical if Sri Lanka is to overcome its economic problems and maintain its sound economic policies. Substantial aid is

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required to help strengthen institutions, expand the country's productive base further and improve social services.

U.S. Interests and Objectives

U.S. interests are to support a viable, independent, and democratic Sri Lanka. The country has a strong record of free elections and social equity. It plays a moderating role in the nonaligned movement, keeps its ports open to the navies of all nations, and is active in international fora in a responsible way. U.S. interest in Sri Lanka also is reflected in the increasing trade between the two countries. The United States is now Sri Lanka's largest export market (about \$185 million in 1983) and sixth largest source of imports (approximately \$114 million in 1983). As a result of the GSL's economic reforms and private sector incentives, U.S. investment in Sri Lanka has risen from \$500,000 in 1978 to an estimated \$15 million in 1983.

In addition, the GSL's development program, which now encourages private enterprise, offers an opportunity to the United States to demonstrate that development can best be achieved by taking a "western" approach. Sri Lanka thus serves as a model of the type of economic development that the United States promotes and supports throughout the world.

A.I.D. Development Strategy

The A.I.D. program will continue to assist Sri Lanka in building the capacity for self-sustained growth. A.I.D. support will emphasize three objectives: 1) expanding food production, 2) increasing employment and income, and 3) improving productivity and well being. These areas are ones in which additional assistance is needed and where A.I.D. has a comparative advantage over other donors. A.I.D. resources will continue to support the GSL's Accelerated Mahaweli Development Program (AMP). The AMP, by bringing a relatively poor area of the country into greater productive use, will provide for expanding food production and improving income and employment, as well as enhancing human well being. A.I.D. assistance will also contribute to these three objectives in programs outside the Mahaweli, with projects in agriculture and rural development -- particularly irrigation and water management -- and for the improvement of health services related to malaria control and water supply and sanitation.

A.I.D. Program (FYs 1984-1985)

A.I.D.'s current program includes Development Assistance, PL 480 food and a Housing Guaranty.

A. Agriculture, Rural Development and Nutrition

Six ongoing projects in the rural development sector -- Mahaweli Basin Development I and II (383-0056 and 383-0073), Mahaweli Environment (383-0075), Mahaweli Sector Support (383-0078), Reforestation and Watershed

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Management (383-0055) and Mahaweli Agriculture and Rural Development (383-0086) -- support the GSL's large, multi-year, multi-donor Mahaweli River Basin development scheme. They help finance the design and construction of an irrigation system encompassing about 62,000 acres of rice land and homesites for some 25,000 settler families. On-farm support systems will be developed to assure productive use of the agricultural base established through irrigation and settlement. Also included is the reforestation of over 24,000 acres of degraded land in the upper catchment of the Mahaweli River and the planting of 35,000 acres of fuelwood forests in the Mahaweli dry zone. Additionally, special attention is being given to developing the institutional capacity to plan and manage natural resources and conserve the environment.

Five additional projects are in process to improve the productivity of Sri Lanka's agricultural sector. The Agricultural Education Development project (383-0049) will put in place a highly trained Faculty of Agriculture and Postgraduate Institute of Agriculture at the University of Peradeniya, together with necessary facilities and equipment to double the number of indigenously trained college graduates and triple the indigenously trained post graduates in the field of agriculture. The Development Services and Training project (383-0044), which will finish in FY 1985, and the new Development Training and Support project (383-0085) provide a sound basis for development through various training activities for up-dating technical and management skills, and through technical assistance and pilot activities directed towards needed policy changes in areas such as energy conservation, environment and women in development. While funding the rehabilitation of older irrigation systems, the Water Management project (383-0057) is also focused on the "software" aspects of irrigation, including the greater efficiency of water use, farmer participation, and systems operation and maintenance. Under the Diversified Agricultural Research project (383-0058), A.I.D. assistance will help improve the GSL's institutional capability to plan and carry out research, seed development and extension on subsidiary field crops which offer significant agricultural potential. Rice, as the most important food grain, will continue to receive some support.

The PL 480 Title I food assistance program contributes to: (1) supporting the government's national agriculture, food and nutrition strategy and related policies, (2) supporting agriculture and rural development, and (3) reducing Sri Lanka's balance-of-payments gap. Wheat flour milled from Title I wheat is distributed to cooperatives, bakeries and registered retail outlets. Low-income families purchase wheat flour and bread from outlets under the GSL's food stamp program which replaced a non-targeted ration that had been provided to everyone. Local currency sales proceeds are used by the government for agriculture and rural development, with emphasis on irrigation and water management activities. A special Title I impact evaluation conducted in 1982 concluded that Sri Lanka's rural development strategies are sound, the GSL's total budgetary commitments to the rural sector are significant, and the Title I program represented a positive balance-of-payments resource.

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B. Health

A.I.D. currently has four projects in this sector. The Malaria Control project (383-0043) has been remarkably successful in helping to reduce the incidence of malaria since 1977. A.I.D. efforts are now focussed on effective institutionalization of the malaria control program. Assistance also includes the introduction of alternative vector control measures and decreasing levels of financing for insecticides as the GSL phases these costs into its budget. The National Institute of Health Sciences project (383-0062) supports the construction of additional training facilities for primary health care workers. The Market Town Water Supply project (383-0063) and the Water Supply and Sanitation Sector project (383-0088) are improving the institutional capacity of the GSL to plan and implement potable water and sanitation programs as they finance the design and installation of such systems. These projects will also help to educate the public in basic health and sanitation measures.

PL 480 Title II voluntary agency programs are administered through CARE, which manages a school-feeding program in collaboration with the Ministry of Education Services, and a Maternal/Child Health (MCH) program and other smaller programs in collaboration with the Ministry of Health. The MCH program addresses three nutritional problems in Sri Lanka: protein-calorie malnutrition, nutrition anemia and vitamin A deficiency. The program reaches approximately 550,000 medically-selected, pregnant and lactating mothers and pre-schoolers through the monthly issuance of a pre-cooked food supplement, Thriposha. A.I.D. is phasing out its support for the school-feeding program over the FY 1985-1987 period. An evaluation of Title II assistance in FY 1982 found the Thriposha program to be one of the better MCH activities sponsored under Title II worldwide, but could not document the nutritional impact of the school-feeding program. A subsequent GSL nutrition study, which indicates that the level of malnutrition in Sri Lanka has increased over the last 10 years, appears to support the view that the school-feeding program is not an effective means of combating this malnutrition problem. As a result, in policy discussions with the GSL, A.I.D. will be encouraging the GSL to focus its resources on combating malnutrition at an earlier stage in the growth cycle through mutually supportive national programs. At the same time, we will be working with the GSL to strengthen the MCH program.

C. Selected Development Activities

The GSL has taken dramatic steps since 1977 to liberalize the economy and encourage private sector development. Rigid controls over foreign exchange and imports have been relaxed, and several tax and other incentives have been introduced to encourage private investment. Promotion of such private investment, both domestic and foreign, which is essential for achieving sustained economic growth, expanded employment, and profitable utilization of Sri Lanka's rich natural resource base is the purpose of the Private Enterprise project (383-0082). This project's principal components are:

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pre-feasibility studies, investment promotion, management training, entrepreneurial development, selected private sector support, and the establishment of a Sri Lankan Business Development Center.

The Low-Income Housing Guaranty program has been assisting the GSL to finance its primarily rural, low cost housing program. In FY 1985 the program's Phase III will be extended to assist those settler households who move to new lands in the Mahaweli area as well as assist the ongoing "Million Houses Program." In addition, assistance may also be provided to Sri Lanka's first, newly created Savings and Loan Association, the Housing Development Finance Corporation and the re-organized State Mortgage and Investment Bank. The capital cost of these programs is supported by A.I.D.'s Housing Guaranty Loan Program. Technical assistance and training are also provided to assist the GSL in the areas of cost recovery, development of appropriate automated management information systems, support for the development of a national housing finance system and national housing policy, and the strengthening of the private sector's role in private housing construction and finance.

The Private Voluntary Organization (PVO) Co-financing project (383-0060) will continue to provide opportunity for local communities to participate in their own development by assisting indigenous and U.S. PVOs undertake collaborative activities which improve the lives of the poor. Eight of the fourteen sub-projects now in various stages of implementation will be completed. Some of the planned achievements for the period are: reforestation of a thousand acres of land in the Mahaweli Project Area; community-based, integrated development of 16 villages resulting in increased agricultural production, increased employment and installation of a village water supply scheme, drinking wells, bathing wells and latrines; provision of books and uniforms to 10,000 school children displaced by the ethnic disturbances of July 1983; rehabilitation of 250 displaced families; establishment of 40 pre-schools and improvement of children's services in 40 fishing villages; vocational training for 80 physically disabled youth; and the establishment of 1,000 home gardens.

Requested Year Program (FY 1986)

Two new and six continuing projects are included in the FY 1986 requested program level. This program, together with the PL 480 Titles III and II programs, is designed to support the GSL's commitment to sound economic policies and emphasis on growth with equity.

A. Agriculture, Rural Development and Nutrition

The Development Assistance request focuses primarily on the agriculture, rural development and nutrition sector. A.I.D.'s continuing interest in the development of the Mahaweli Basin is financed through the Mahaweli Agriculture and Rural Development project (383-0086). Irrigation in other parts of the country will be the focus of attention in the new FY 1986 Irrigation Systems Management project (383-0080).

SRI LANKA

Research, planning, evaluation and management improvement are highlighted in the Diversified Agricultural Research (383-0058) and Development Training and Support (383-0085) projects which will receive incremental funding. The PVO Co-financing project (383-0060), drawing from the four program accounts, will continue with collaborative development in agriculture, health, education and other development activities.

A new Agriculture Planning project (383-0083) will improve the GSL's capability to allocate resources and manage their agriculture and rural development programs. The project will strengthen the analysis and planning capacity at both national and local levels.

B. Health

Incremental funding is planned for the ongoing Malaria Control project (383-0043) and the continuing Water Supply and Sanitation Sector Project (383-0088).

C. Other Programs

Multi-year PL 480 Title III - Food assistance will contribute to reducing Sri Lanka's food gap; support the GSL's national agriculture, food and nutrition strategy and related policies; and generate local currency to support rural development activities with a priority on irrigation, water management and diversified agricultural production. A Title III program is planned to enhance the development effect of the PL 480 program.

PL 480 Title II - Voluntary agency Maternal/Child Health and school-feeding programs will continue.

SUMMARY OF ACTIVE AND PROPOSED PROJECTS
(IN THOUSANDS OF DOLLARS)

PROGRAM: SRI LANKA	PROJECT TITLE	* L PROJECT / NUMBER	FY OF INITIAL OBLIG	FY OF FINAL OBLIG	TOTAL PROJECT COST AUTHO PLANED	-THROUGH FY84-		-ESTIMATED FY85-		-PROPOSED FY86-	
						OBLIGATIONS	EXPENDITURES	OBLIGATIONS	EXPENDITURES	OBLIGATIONS	EXPENDITURES
AGRICULTURE, RURAL DEV. AND NUTRITION											
	RICE RESEARCH	L 383-0040	77	77	3,565	3,565	3,500	---	65	---	---
	PADDY STORAGE AND PROCESSING I	L 383-0041	78	78	4,775	4,775	4,722	---	53	---	---
	DEVELOPMENT SERVICES AND TRAINING	G 383-0044	78	84	6,500	6,500	4,504	---	1,996	---	---
	AGRICULTURAL BASE MAPPING	L 383-0045	78	78	3,863	3,863	3,340	---	523	---	---
	AGRICULTURAL EDUCATION DEVELOPMENT	G 383-0049	78	82	7,500	7,500	5,971	---	889	---	640
	REFORESTATION AND WATERSHED MANAGEMENT	G 383-0055	80	95	1,450	1,450	1,250	885	200	359	---
	REFORESTATION AND WATERSHED MANAGEMENT	L 383-0055	80	85	9,000	9,000	6,843	654	2,157	2,391	---
	MAHAWELI BASIN DEVELOPMENT I	L 383-0056	80	80	10,000	10,000	10,000	4,507	---	2,756	---
	WATER MANAGEMENT I	G 383-0057	79	84	5,100	5,100	3,608	---	1,166	---	2,737
	WATER MANAGEMENT I	L 383-0057	79	84	10,800	10,800	10,900	5,912	---	3,228	---
	DIVERSIFIED AGRICULTURAL RESEARCH	G 383-0055	84	88	7,900	7,900	790	4	3,040	836	1,460
	DIVERSIFIED AGRICULTURAL RESEARCH	L 383-0058	84	88	3,500	3,500	1,760	---	1,540	1,630	---
	PVO CO-FINANCING	G 383-0060	79	87	2,500	2,500	1,100	545	402	806	498
	MAHAWELI BASIN DEVELOPMENT II	G 383-0073	81	85	3,000	3,000	1,000	34	2,000	1,486	---
	MAHAWELI BASIN DEVELOPMENT II	L 383-0073	81	85	107,000	107,000	95,294	40,736	11,706	43,400	---
	MAHAWELI ENVIRONMENT	G 383-0075	82	84	5,000	5,000	5,000	435	---	1,633	---
	MAHAWELI SECTOR SUPPORT	L 383-0079	81	83	50,000	50,000	50,000	37,114	---	5,258	---
	IRRIGATION SYSTEMS MANAGEMENT	* G 383-0080	86	89	---	5,000	---	---	---	---	---
										1,500	300

* Refers to the planned project summary sheet
C Level of effort activity

FY of final obligation column - All projects in this column with an initial obligation date before December 31, 1984 are based on the authorized date. For all projects with an initial obligation date after December 31, 1984 the FY of final obligation is based on a planned date.

SUMMARY OF ACTIVE AND PROPOSED PROJECTS
(IN THOUSANDS OF DOLLARS)

PROGRAM: SRI LANKA

PROJECT TITLE	* L PROJECT / NUMBER	FY OF INITIAL OBLIG	FY OF FINAL OBLIG	TOTAL PROJECT COST AUTH'D PLANNED	-THROUGH FY84- OBLIG EXPENDI TURES	-ESTIMATED FY85- OBLIG EXPENDI TURES	-PROPOSED FY86- OBLIG EXPENDI TURES	CP 86			
								OBLIG	EXPENDI TURES		
IRRIGATION SYSTEMS MANAGEMENT	* L 383-0080	86	89	---	---	---	---	10,000	500		
PRIVATE ENTERPRISE PROMOTION	G 383-0082	83	83	1,500	1,500	---	---	---	---		
AG PLANNING	* G 383-0083	86	89	---	---	---	---	---	---		
DEVELOPMENT TRAINING & SUPPGRT	G 383-0035	85	89	---	---	---	---	---	---		
MAHAWELI AGRICULTURE AND RURAL DEV	G 383-0086	85	88	---	---	---	---	---	---		
MAHAWELI AGRICULTURE AND RURAL DEV	L 383-0085	85	89	---	---	---	---	---	---		
TOTAL FOR ACCOUNT GRANTS				242,953	316,153	216,340	115,456	26,215	68,765	28,041	47,257
LOANS				40,450	62,950	29,740	16,071	7,102	9,461	7,508	9,111
				202,503	253,203	187,100	100,365	19,113	59,304	20,533	38,146
HEALTH											
MALARIA CONTROL	G 383-0043	84	86	4,000	4,000	1,000	20	2,000	1,320	1,000	1,300
MALARIA CONTROL	L 383-0043	78	86	26,000	26,000	24,000	15,388	2,000	4,000	---	3,500
PVO CO-FINANCING	G 383-0060	79	87	1,224	1,224	824	331	100	165	100	240
NATIONAL INSTITUTE OF HEALTH SCIENCES	G 383-0062	80	82	2,200	2,200	2,200	170	---	1,005	---	1,025
MARKET TOWN WATER SUPPLY	L 383-0063	80	82	6,000	6,000	6,000	2,200	---	1,460	---	1,600
WATER SUPPLY & SANITATION SECTOR	G 383-0089	84	89	5,000	5,000	500	---	2,000	1,310	1,500	830
WATER SUPPLY & SANITATION SECTOR	L 383-0088	84	89	7,300	7,300	2,300	---	4,100	1,220	900	1,530
TOTAL FOR ACCOUNT GRANTS				51,724	51,724	36,824	19,109	10,200	10,480	3,500	10,025
LOANS				12,424	12,424	4,524	521	4,100	3,800	2,600	3,395
				39,300	39,300	32,300	17,588	6,100	6,680	900	6,630
EDUCATION AND HUMAN RESOURCES											

* Refers to the planned project summary sheet

G Level of effort activity

FY of final obligation column - All projects in this column with an initial obligation date before December 31, 1984 are based on the authorized data. For all projects with an initial obligation date after December 31, 1984 the FY of final obligation is based on a planned date.

SUMMARY OF ACTIVE AND PROPOSED PROJECTS
(IN THOUSANDS OF DOLLARS)

PROGRAM: SRI LANKA

PROJECT TITLE	* L PROJECT / NUMBER	FY OF INITIAL OBLIG	FY OF FINAL OBLIG	TOTAL PROJECT COST AUTH'D PLANNED		-THROUGH CBLIG ATIONS	FY84- EXPENDI TURES	-ESTIMATED CBLIG ATIONS	FY85- EXPENDI TURES	-PROPOSED OBLIG ATIONS	CP 86 FY86- EXPENDI TURES
PVO CO-FINANCING	G 383-0063	79	87	959	959	659	377	200	165	100	140
TOTAL FOR ACCOUNT GRANTS				959	959	659	377	200	165	100	140
LOANS				---	---	---	---	---	---	---	---
SELECTED DEVELOPMENT ACTIVITIES											
PVO CO-FINANCING	G 383-0060	79	87	1,200	1,200	300	103	250	100	359	200
PRIVATE ENTERPRISE PROMOTION	G 383-0062	83	83	1,500	1,500	1,500	---	---	295	---	465
PRIVATE ENTERPRISE PROMOTION	L 333-0032	83	83	1,000	1,000	1,000	---	---	200	---	300
TOTAL FOR ACCOUNT GRANTS				4,300	4,300	3,300	103	250	595	359	965
LOANS				3,300	3,300	2,300	103	250	395	359	665
				1,000	1,000	1,000	---	---	200	---	300
TOTAL FOR COUNTRY GRANTS				299,936	373,136	257,623*	135,045	36,565	80,005	32,000	53,337
LOANS				57,133	79,533	37,223	17,072	11,652	13,821	10,567	13,311
				242,803	293,503	220,400	117,973	25,213	66,184	21,433	45,076

* FY 1984 totals include \$1,066,000 in reobligations.

* Refers to the planned project summary sheet

C Level of effort activity

FY of final obligation column - All projects in this column with an initial obligation date before December 31, 1984 are based on the authorized date. For all projects with an initial obligation date after December 31, 1984 the FY of final obligation is based on a planned date.

Title Irrigation Systems Management		Funding Source	AG, RD & N 1,500 (G) 10,000 (L)	Health	PROPOSED OBLIGATION (In thousands of dollars)		
Number 383-0080		<input checked="" type="checkbox"/> NEW	Population	ED. & HR	FY 1986 1,500 (G); 10,000 (L)		Life of Project Funding 5,000 (G); 14,000 (L)
<input checked="" type="checkbox"/> GRANT <input type="checkbox"/> LOAN <input type="checkbox"/> CONTINUING				Sel. Act.	Initial Obligation	Estimated Final Obligation	Estimated Completion Date of Project
					FY 1986	FY 1989	FY 1992

Purpose: To develop a national institutional capability to increase food production from existing irrigated lands, and to carry out improvements resulting in increased food production on selected irrigation schemes.

Project Description: The primary emphasis of this project is to develop the Government of Sri Lanka's (GSL) institutional capacity to manage and operate irrigation systems better, and with the full participation of farmers. Experience gained from the A.I.D. supported Water Management Project shows that the establishment of farmer organizations is essential for introduction of proper water management practices and effective operation and maintenance of irrigation schemes. Sri Lanka has 61 major irrigation schemes serving 650,000 acres. This project will rehabilitate and improve five of these schemes which irrigate approximately 28,000 acres. The enhanced GSL institutional capacity will result in better water management practices in all of the major schemes, particularly in operations and maintenance procedures. The project also will strengthen an irrigation training institute for officials dealing with irrigation, with special emphasis on irrigation system operation and management.

Implementation policies will assure that: (1) multidisciplinary studies of irrigation systems will determine the extent of rehabilitation required, farmer attitudes, and prospective economic benefits; (2) priorities will be on establishing system safety, improving water distribution and control, and improving ease of operation and maintenance; (3) farmers will be organized into water user associations, and trained and encouraged to adopt improved improved on-farm water management practices and crop rotations; (4) irrigation system committees will be established at the district level to provide general management of irrigation systems and to coordinate complementary inputs such as credit and fertilizer; (5) a monitoring system will be established to measure system performance against established goals; and (6) private sector participation in the rehabilitation and improvement of irrigation systems will be encouraged.

Relationship of Project to A.I.D. Country Strategy: This project will make a direct contribution to the attainment of A.I.D. strategy objectives, particularly increased food production and employment generation. There is ample scope to significantly improve the efficiency of Sri Lanka's 61 major irrigation schemes which would immediately raise food production. While many of these schemes require some physical rehabilitation, their long-term viability will depend upon the improved organizational and policy framework in which they are operated. This project will assist the GSL to strengthen its program in irrigation management, to set up irrigation system committees at the district level, to improve technical system and to organize farmer water-users associations at the village level. The design, testing and evaluation of farmer associations initiated under A.I.D.'s Water Management Project will be modified as conditions require and replicated under this project. The policy dialogue will continue in order to obtain appropriate policy changes involving water law, budgetary allocations, cost recovery principles, and organizational structures to serve farmers better.

Host Country and Other Donors: The primary GSL implementing agency will be the Irrigation Department, Ministry of Lands and Land Development. The World Bank also has scheduled a major irrigation rehabilitation project beginning in 1985. Coordination between A.I.D. and the Bank is under way in terms of the basic approach to irrigation rehabilitation and specific projects where rehabilitation will take place. A.I.D.'s institutional emphasis is expected to be a major influence on the Bank project.

Beneficiaries: 21,000 low-income farm families will benefit from the rehabilitation, operations, and maintenance improvements of five major irrigation schemes in the Polonnaruwa and Amparai districts. Farmers at the ends of the irrigation systems, who generally have the lowest incomes, will benefit most. 150,000 farm families are expected to benefit from improved GSL management of other irrigation programs throughout the country.

PROGRAM: SRI LANKA

PLANNED PROGRAM SUMMARY SHEET

Title Agriculture Planning		Funding Source	AG, RD & N	Health	PROPOSED OBLIGATION (In thousands of dollars)		
Number 383-0083		<input type="checkbox"/> NEW <input checked="" type="checkbox"/> GRANT <input type="checkbox"/> LOAN <input type="checkbox"/> CONTINUING	1,000 G		FY 1986	Life of Project Funding	
			ED. & HR	1,000 G		Initial Obligation	Estimated Final Obligation
				Sel. Act.	FY 1986	FY 1989	FY 1992
						4,000 (G);	3,000 (L)

Purpose: To improve resource allocation and management in agriculture and rural development through a strengthened, integrative analysis and planning capacity at national and local levels.

Problem Description: Allocation and management of productive resources for sustained agricultural and rural development in Sri Lanka have been constrained by (1) the absence of an integrated strategy framework within which to evaluate alternatives and allocate resources, and (2) by the inadequacy of planning (i.e., establishment of priorities, program and project design, analysis and evaluation, information dissemination) and management capabilities at all levels. The result has been various institutions working occasionally at cross purposes or duplicating efforts, considerable misallocation of the Government of Sri Lanka's (GSL) scarce development resources, and delays in the design and implementation of programs and projects. The first of these constraints is being addressed for the first time by a National Agriculture, Food and Nutrition Strategy (NAFNS) formulation exercise, led by the National Planning Division and assisted by A.I.D. The Agricultural Planning project will focus primarily on the second constraint identified above, building on and supporting the NAFNS work through upgraded planning and management capabilities of the relevant line ministries and local-level administrative bodies.

At the macro-level, the project will be implemented through the National Planning Division (NPD), Ministry of Finance and Planning, which is the key institution in the national planning process, and the major line ministries in agriculture and rural development, primarily the Ministry of Agricultural Development and Research, Ministry of Rural Industrial Development, and the Ministry of Lands and Land Development. At the local level the project will use short-term technical assistance and in-service training to improve the capabilities of the District Development Councils in (1) coordinating and managing agriculture and rural development activities and (2) basic appraisal and monitoring for projects. Project assistance to these institutions will

consist primarily of training and short-term technical assistance, and funding for special research and analysis activities.

Relationship of Project to A.I.D. Country Strategy:

Expansion of food production, combined with improved national resource management, is one of the three major A.I.D. objectives in Sri Lanka. A second objective is increased incomes, particularly in the rural areas. This project contributes to achieving these objectives and follows naturally from our present involvement in the National Agriculture, Food and Nutrition Strategy exercise. Major emphasis of this project will be on improving GSL appreciation for, and understanding of, policy alternatives and developing institutional capabilities to better plan and manage the allocation of development resources. The institutional development envisaged will work at both the macro and micro levels, the former to reflect national goals and priorities and the latter to facilitate local involvement and input, and will promote improved coordination between the two levels.

Host Country and Other Donors: Recent experience with the National Agriculture, Food and Nutrition Strategy has highlighted the problems and potential of sound agricultural planning, and an improved agricultural planning capacity has emerged as one of the important Strategy recommendations. At the present time there is no other substantive donor involvement in this area.

Beneficiaries: Direct beneficiaries of the project will be the participating institutions, ultimately affecting agriculture and rural development countrywide.

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SL 85-1

FROM: Vice President and Secretary

May 6, 1985

SRI LANKA AID GROUP

Notice of Meeting

1. A meeting of the Sri Lanka Aid Group will be held on Thursday, June 20, 1985, at the Bank's European Office, 66 Avenue d'Iena, Paris, France.
2. The Agenda and the documents for the meeting, as well as a Note on Administrative Arrangements, will be issued shortly.
3. Participants are requested to send names of delegates to the meeting to the Vice President and Secretary or Deputy Secretary of the World Bank in Washington by Friday, May 24, 1985.

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SL 85-3

FROM: Vice President and Secretary

May 22, 1985

SRI LANKA AID GROUP

1. Attached for the information of the participants in the meeting of the Sri Lanka Aid Group, to be held at the Bank's European Office in Paris on Thursday, June 20, 1985, are the following:

(a) The Agenda; and

(b) Note on Administrative Arrangements

2. Participants are reminded to send the names of delegates to the meeting to the Vice President and Secretary or Deputy Secretary of the World Bank in Washington DC as soon as possible.

Distribution

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Senior Vice Presidents
Senior Management Council
Vice Presidents, IFC
European Office
Colombo Office

Executive Director for Sri Lanka
International Monetary Fund
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SRI LANKA AID GROUP MEETING

Paris, Thursday, June 20, 1985

AGENDA

1. Statement by the World Bank
2. Statement by the IMF Representative
3. Statement by the Asian Development Bank Representative
4. Statement by the Head of the Sri Lankan Delegation
5. Discussion on Sri Lanka's Recent Economic Developments and Policies for Growth
6. Discussion of Aid Requirements

South Asia Country Programs Department
May 22, 1985

SRI LANKA AID GROUP MEETING

Paris, Thursday, June 20, 1985

ADMINISTRATIVE ARRANGEMENTS

Location

1. The meeting of the Sri Lanka Aid Group will be held in Room A of the World Bank's European Office, 66 Avenue d'Iena, 75116 Paris, France (Telephone: 723-54-21), on Thursday, June 20, 1985. The opening session will begin at 9:30 a.m.

General Information

2. Information about the meeting and other arrangements may be obtained during meeting hours from the Meeting Reception Desk. Outside the meeting hours, information may be obtained from the Bank's Paris Office (Telephone: 723-54-21).

Simultaneous Interpretation

3. Simultaneous interpretation - English/French, French/English - will be in operation during the meeting. Delegates who intend to speak from the prepared text can assist the interpreters by providing a copy of the text to the Meeting Secretary beforehand.

Documents

4. A limited number of copies of the Bank report entitled "SRI LANKA: Recent Economic Developments and Policies for Growth" (No.5628-CE) dated May 14, 1985 will be available at the Meeting Reception Desk. This report was distributed to participants on May 22, 1985

Hospitality

5. The Minister of Finance and Planning, Government of Sri Lanka, invites all delegation members to a reception at Hotel Ritz, 15 Place Vendome, Paris 1, on Thursday, June 20, 1985 at 6:30 p.m.

South Asia Country Programs Department
May 22, 1985.

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INCOMING
TELEGRAM

PAGE 01 NEW DE 14177 071440Z
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TO SECSTATE WASHDC 6175
INFO AMEMBASSY PARIS

UNCLAS NEW DELHI 14177

AIDAC

E.O. 12356: N/A
SUBJECT: INDIA CONSORTIUM MEETING

REF: PARIS 23142

GEORGE KENNEY, ECONOMIC OFFICER AT EMBASSY/DELHI,
ADVICES THAT BECAUSE HE HAS NO TRAVEL FUNDS AT HIS
DISPOSAL. HE CANNOT ATTEND THE MEETING. STREEB .

LOG ACTION

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AMEMBASSY COLOMBO PRIORITY
AMEMBASSY NEW DELHI PRIORITY

UNCLAS PARIS 23142

AIDAC

E. O. 12356: N/A

TAGS: OTRA

SUBJECT: SRI LANKA AID GROUP MEETING, JUNE 20, 1985 AND
INDIA CONSORTIUM MEETING, JUNE 18-19, 1985

REF: STATE 153635

1. EUGENE S. STAPLES, DAA, BUREAU FOR ASIA AND THE NEAR EAST, AID - SINGLE/BATH RESERVED HOTEL CALIFORNIA, 16 RUE DE BERRI, PARIS 8TH, TEL: 359-9300, FROM JUNE 17 TO JUNE 21.
 2. JOHN N. GUNNING, PROGRAM OFFICER, OFFICE OF SOUTH ASIA AFFAIRS, AID - SINGLE/BATH RESERVED HOTEL ETAP SAINT HONORE 15, RUE BOISSY D'ANGLAS, PARIS 8TH, TEL: 266-9362, FROM JUNE 15 TO JUNE 21.
 3. ROSS RODGERS, COUNTRY OFFICER FOR SRI LANKA, STATE DEPARTMENT - SINGLE/BATH RESERVED HOTEL FREMIET, 6 AVENUE FREMIET, PARIS 16TH, TEL: 524-5206, FROM JUNE 15 TO JUNE 21.
 4. GEORGE KENNEY, ECONOMIC OFFICER, AMEMBASSY NEW DELHI - SINGLE/BATH RESERVED HOTEL FREMIET, FROM JUNE 15 TO JUNE 21.
- CHRISTOPHER D. CROWLEY, PROGRAM OFFICER, USAID, NEW DELHI - SINGLE/BATH RESERVED HOTEL MONT BLANC, 51 RUE LAURISTON, PARIS 16TH, TEL: 727-4967, FROM JUNE 16 TO JUNE 23.
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TO SECSTATE WASHDC 5554

UNCLAS NEW DELHI 12990

FOR CHRISTOPHER D. CROWLEY, ASIA BI

FOLLOWING RECEIVED ACTION NEW DELHI 22 MAY 85 REPEATED
FOR YOUR INFO:

QUOTE

UNCLAS PARIS 20641

USOECD

AIDAC

E. O. 12356: N/A

TAGS: OTRA

SUBJECT: HOTEL RESERVATION FOR INDIA CONSULTATIVE
GROUP MEETINGS (JUNE 18-19)

REF: NEW DELHI 012292

DOUBLE/BATH RESERVED HOTEL MONT BLANC, 28 RUE DE LA
HUCHETTE, PARIS 5TH, TEL: 354-4944, FROM JUNE 16 TO
JUNE 23, FOR MR. CHRISTOPHER D. CROWLEY.

PLEASE CONFIRM TO STATE AID/ASIA/BI ATTN ANN MCDONALD,
STREATOR UNQUOTE STREEB

cc: JNB

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PAGE 01 STATE 153635 4268 046225 AID3471
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ORIGIN OFFICE PPDC-01
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MAST-01 /014 AS 1-20

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APPROVED BY: AID/PPC/DC: JDUDIK-GAYOSO
AID/ANE/ASIA/PNS: JGUNNING (SUBS) AID/ANE/ASIA/PNS: JMANLEY (SUBS)
AID/DAA/ANE/ASIA: ESSTAPLES STATE/NEA/INS: RODGERS
AID/PPC/DC/DAC: CHWICKHAM

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TO AMEMBASSY PARIS PRIORITY
INFO AMEMBASSY CO. OMBO PRIORITY
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E. O. 12356: N/A

TAGS:

SUBJECT: SRI LANKA AID GROUP MEETING, JUNE 20, 1985 AND
INDIA CONSORTIUM MEETING, JUNE 18-19, 1985

REF: PARIS 18497 AND STATE 114955

FOR FRANK CORREL, MISSION DIRECTOR/SRI LANKA
FOR GEORGE KENNEY, ECONOMIC OFFICER, USEMBASSY/NEW DELHI

1. EUGENE S. STAPLES, DAA, BUREAU FOR ASIA AND THE NEAR EAST, A. I. D. (HEAD OF DELEGATION).
2. JOHN N. GUNNING, PROGRAM OFFICER, OFFICE OF SOUTH ASIA AFFAIRS, A. I. D.
3. ROSS RODGERS, COUNTRY OFFICER FOR SRI LANKA, STATE DEPARTMENT (REP FOR SRI LANKA AND INDIA).
4. INDIA ONLY: CHRIS CROWLEY, PROGRAM OFFICER, USAID, NEW DELHI.
- A. GEORGE KENNEY, ECONOMIC OFFICER, USEMBASSY/NEW DELHI.
5. SRI LANKA ONLY: FRANK D. CORREL, DIRECTOR, USAID/SRI LANKA.
6. REQUEST SWB HOTEL ETAP SAINT HONORE FOR RODGERS, CROWLEY AND KENNEY FOR NIGHTS OF JUNE 15 THRU JUNE 20.
7. ADJUST JOHN GUNNING'S RESERVATION AT HOTEL ETAP SAINT HONORE TO A NEW DEPARTURE DATE OF FRIDAY, JUNE 21. ARRIVAL DATE SATURDAY, JUNE 15 REMAINS AS STATED REFTEL (PARIS 18497, 7 MAY 85).
8. PLEASE CONFIRM HOTEL RESERVATIONS. SHULTZ

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